LIFE INSURANCE INCOME SETTLEMENTS

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Income Settlements

THEIR

Functions, Problems and Administration

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CHAPTER I

THE SETTLEMENT OPTIONS

A well-rounded insurance program aims to achieve more than merely to cover the immediate expenses resulting from the insured's death. The primary purpose of most life insurance is to indemnify dependents for the loss of income resulting from the premature death of the breadwinner, but a policy payable in a single sum, though its amount may be adequate, does not guarantee fully to achieve this end. Such a life insurance policy may actually impose a burden upon the beneficiary, who must invest the proceeds in order to obtain an adequate income for future needs. The beneficiary often is totally lacking in investment experience, so that she is misled by unscrupulous or unwise advisors into making wildcat investments. Worse yet, she may fail to appreciate the full magnitude of her responsibilities and may dissipate upon trivialities the entire insurance estate shortly after the insured's death. Many instances can be cited where the insurance proceeds were quickly consumed through unwise investment or dissipation with the result that the life insurance protection that the deceased left his dependents failed miserably to achieve its purpose. In this age in which security is the prime object, it is not proper that the beneficiary be subjected to these responsibilities and to these hazards.

Settlement Options and Trusts. There are three methods by which the insured may provide for the sound investment of the life insurance proceeds after his death: the first is to provide in the policy for payment of the proceeds in the form of income instead of in a single sum; the second is for the insurer to retain the proceeds, as trustee, to be administered in the manner set out in a trust certificate attached to the policy; the third method is to arrange through a beneficiary designation for payment of the insurance proceeds to a named trustee, usually a trust company, who will administer the proceeds in accordance with a trust agreement entered into with the policyholder.

The first method has its origin in the provisions of the contract. Many policies are issued today which provide for payment in the form of income, while those which are payable in a single sum usually include settlement option provisions which set forth several plans by which the proceeds may be retained by the company and paid in equal periodical instalments. The policyholder may direct that the beneficiary shall be paid under one of these settlement options instead of in a single sum.

The second method warrants little discussion, as instances of its use are very rare, only a few life insurance companies being chartered to conduct a trust business. This method differs very little from the first, the only difference being that it has been construed as creating a trustee and cestui que trust relationship under which the trust fund need not be segregated from the other assets of the trustee, while the first method has been construed as merely a debtor and creditor relationship.

The third method removes the burden from the insurance company and places it squarely upon the insured's attorney and his trustee. The placing of the insurance in a life insurance trust, whether through immediate assignment to the trustee or through merely naming the trustee as death beneficiary, the insured reserving all rights under the policy, is a more complicated transaction than might at first appear. The transaction involves the combining of two complicated legal instruments, the policy and the trust, and there is some doubt as to which takes precedence when the provisions of the two instruments are contradictory.[1] The judiciary have never interpreted this question, there being no cases in point to date. If, for example, the policy by its provisions permits the policyholder to remove the trustee-beneficiary in favor of a third party, while the trust

[1] See Appendix A.1.

agreement includes no provision by which the insurance may be removed, it has been suggested that any right set forth in the insurance policy may not be exercised, should such action defeat the purpose of the trust.[2] Accordingly we recommend strongly that all life insurance agents insist that the insured consult his attorney before deciding to place his insurance in a life insurance trust.[3]

Much has been written upon the relative merits of these three methods,[4] so that we shall not make an elaborate comparison. Owing to the infrequency of the second, most discussions of this question resolve themselves into a comparison of the first and third methods outlined here. There is little difference between the average yield derived over a prolonged period of time from these two methods. Retention of the proceeds by the company under a settlement option is of advantage in that the policyholder and beneficiary can determine in advance approximately the income that will be payable, since notwithstanding changing conditions the income will not fall below a guaranteed minimum, and in that this method provides greater security since all of the assets of the insurer are behind it. Settlement with a trust company is preferable if it is desired that the income vary as conditions change or if the life insurance proceeds are to be combined with other assets, all of which are to be administered under the trust. A life insurance company can offer a plan of settlement that is based upon life contingency which a trust company could not undertake, while a trust company could agree to restraints and limitations which are of such a nature that a life insurance company would not wish to be bound by them. Generally speaking, a life insurance company can administer a simple settlement best, while, if the settlement is more complicated, a trust company is preferable.

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[2] See Appendix A.2.

[3] See Appendix A.3.

[4] See MacLean, "Life Insurance," 1940 Edition, page 217, and Horton, "Making the Best Use of Your Insurance," pages 19-24. Also see chart, page 147, "Safeguarding Life Insurance Proceeds," by Wheeler and Todd.

Development of Settlement Options. The inclusion of a provision for payment of the policy proceeds in the form of income is not of recent origin. Prior to the turn of the century policies were issued which were payable in instalments instead of in a single sum, and some single sum policies included provisions for optional modes of settlement. These provisions, however, received little attention until after World War I, and it was not until the years following the depression of 1929 that the investment by or for the beneficiary of life insurance proceeds in the life insurance company itself became a frequent procedure. Deferred settlements, or, as we shall call them, *Supplementary Contracts*, constitute today a very important aspect of life insurance administration and a constantly increasing item in the company's liabilities.[5]

The extensive use of income settlements has resulted in a further technical problem for the soliciting agent. A mere knowledge of the different available plans of insurance and their relative advantages and disadvantages is no longer sufficient, since to this knowledge must be added a thorough understanding of the different methods of settlement which may be applied to each. Furthermore, the emphasis in selling no longer is upon the face amount of insurance, but, rather, upon the income which will be available to the beneficiary, so that the policyholder actually may not know the full face amount of life insurance he carries but only the income which it will provide.

Deferred settlements could be of advantage to the insurer, provided the guaranteed rate of return is not too high[6] and there is an adequate outlet for investments, in that they would increase the funds available for further investment and reduce the number of immediate large disbursements. They are of advantage to the agent in that they facilitate sales, and experience has shown that policies

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[5] In one company, whose experience is by no means unusual, the supplementary contract account has increased by five times as much in the past fifteen years, has tripled itself in the past ten years and has increased by 62% in the past five years.

[6] See Appendix A.4

that are sold on this basis are less likely to lapse. When the amount of income instead of the amount of insurance is stressed, the prospect is more impressed with the necessity for carrying a substantial amount of life insurance protection.

Life Insurance Programming. The use of income settlements has introduced a new feature in life insurance selling; namely insurance programming. Much has been written on this subject, and the science of arranging income settlements has been extended to cover many varying needs. As a result the whole subject has been greatly complicated, but the need for simplicity is receiving increasing recognition.

In a well-rounded insurance program, due consideration should be given to each of the following needs: a cleanup fund to cover last illness and burial expenses and any outstanding unpaid debts, a readjustment income by which the total income of the insured is continued temporarily to enable the beneficiary to readjust to her changed circumstances, an emergency fund set aside to meet future unforeseen contingencies, an income to provide for the insured's children until they are old enough to earn their own living, a life income for any persons such as a wife or parents who are wholly dependent upon the insured for their livelihood, a fund for the education of the insured's children, mortgage or business protection and provision for the insured's own retirement. Other items that may be included in the insurance program are charitable bequests, an annual birthday, Christmas or anniversary present, and the preservation of a portion of the estate for use in the distant future, but such items are included more out of sentiment than necessity. The cleanup fund and business protection are outside the realm of income settlements, but should be included in any well-rounded life insurance program.

It is difficult to make a comparative evaluation of the various needs listed above, as such an evaluation would depend upon the particular circumstances of the insured, his income, the amount of insurance he carries, the size of his family, the extent to which it is dependent upon him, and the general nature of his estate. In some situations some of these needs may be ignored altogether while in other cases they may be of prime importance. There are, however, certain principles which would apply in almost every case, and which we shall state for the agent's guidance in arranging an insurance program.

It would be difficult for the beneficiary, for example, if the entire insurance estate were tied up in an income settlement and there were not sufficient funds available to meet last-minute expenses. Likewise, it is ridiculous to set aside a substantial sum for a child's college education if the child is not sufficiently provided for before he is ready for college. It is unwise to tie up the insurance proceeds in income settlements for the family, even if the income thus provided is more than adequate, if there are no funds available for sudden unforeseen emergency expenses. The readjustment income may be eliminated as a really vital need by providing a more than adequate cleanup fund. Finally it is impractical to tie up a substantial portion of the insurance at the sacrifice of other vital needs in a life income for the insured's wife or other dependent if the income thus provided is not nearly enough for her to live on, as the filling of this need calls for a substantial amount of insurance and the proceeds thus applied, if inadequate, might better be put to another purpose.

The Settlement Option Provision. By adding to or including in the policy a special rider or provision [7] in which is set forth the settlement options, all policies that are payable in a single sum may be used to provide income. Though practices among different companies are not entirely uniform, it has generally become the accepted rule that the settlement option privilege applies to the net proceeds payable upon the insured's death, upon maturity of the policy as an endowment or upon surrender of the policy for its

[7] See Appendix B.1. hereafter referred to as the Settlement Option Rider.

cash value,[8] while it is not generally extended to other proceeds such as reserves released through change in plan of insurance. The insured [9] may designate a settlement option under which the beneficiary shall receive the proceeds at the insured's death instead of in a single sum. Should no election have been made prior to the insured's death, the beneficiary, then, may exercise the settlement option privilege for her own benefit. At maturity of a policy as an endowment, the recipient of the maturity proceeds may elect a settlement option, as may the payee entitled to receive the cash surrender value.

Most policies include four different optional modes of settlement. These are the Fixed Period Option,[10] providing for payment of income during a specified number of years, the Fixed Amount Option,[11] providing for payment of periodical income for a fixed amount until the proceeds and interest thereon are exhausted, the Life Income Option,[12] providing for the payment of a life annuity with a specified number of guaranteed payments, and the Interest Option,[13] providing for the retention of the entire proceeds, interest thereon being paid periodically. Some companies include an additional option or a further modification of the Life Income Option extending to the payee the right to convert the proceeds to a refund or life annuity.[14] Other options sometimes available upon request are the Joint and Survivorship and the Instalment Bond or Family Income Options. The former provides for the payment of a life income throughout the duration of two lives, and the latter is similar to the Fixed Period Option except that a substantial single sum is paid at the end of the income period.

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[8] It has become the accepted practice whenever the policy is silent upon the point to request the company to issue a letter stipulating that the settlement option privilege is extended to cash surrender proceeds.

[9] In this text we shall use the term "insured" loosely to apply either to the life insured or to the owner of the policy.

[10] Option 1 in Appendix B.1.

[11] Option 4 in Appendix B.1.

[12] Option 2 in Appendix B.1.

[13] Option 3 in Appendix B.1.

[14] Annuities will be discussed in more detail in the next chapter.

Under the Fixed Period Option it is desirable to show in the rider in tabular form the income available per $1,000.00 of proceeds depending upon the period during which it will be paid and the method of payment. Likewise, under the Life Income Option it is desirable to set forth the income available at the different ages, for this option involves life contingencies, and the income thereunder is determined by the payee's age. Under the Interest Option it is unnecessary to include tables, and under the Fixed Income Option it is impractical, as complete information cannot be conveyed in tabular form.

Beyond a detailed description of the various options available, the provisions of the settlement Option Rider is quite simple, but there are several additional provisions which should be included in order that the contract be complete. Among these are any limitations upon the nature of the payee, the procedure by which the income settlement is put into effect,[15] a provision allowing additional surplus interest, any limitations upon the right to withdraw the balance on deposit or any unpaid instalments, the right to receive payment at more or less frequent intervals, the minimum amount which may be placed under a settlement option and the disposition of any balance at the death of the payee.

The settlement option privilege was originally intended only for personal beneficiaries who were dependent upon the insured for their livelihood. It was not intended for impersonal beneficiaries such as corporations, trust companies, charitable institutions, executors or administrators.[16] Accordingly, it is advisable to include in the contract a provision to the effect that the payee must be a natural person acting in his or her own right[17] although many companies merely require through contract provision that the company's consent is an essential condition to an election by an impersonal payee. As an alternative a special Settlement Option Rider with limited options and pro-

[15] This will be discussed in detail in Chapter III.

[16] The supplementary contract payee is further discussed on pages 44-47.

[17] See final sentence of Clause 1 of Appendix B.1.

visions could be made available for business insurance. Such a rider in one instance contains only the Fixed Period and the Interest Options with the maximum period of retention limited to ten years.

In the case of participating companies it is intended that the payee under a Supplementary Contract share in the company's surplus in accordance with his contribution thereto. The share of such payee is determined entirely from the factor of excess interest earnings. The rate set forth in the Settlement Option Rider, as the rate upon which the policy reserves are determined, is based upon the assumption that the insurer will realize this return upon the investment of the proceeds so retained, so that any earnings over and above this rate should be paid as surplus. The Settlement Option Rider provides for the payment of such surplus interest, the amount to be paid being determined by the directors of the company.[18]

The right to withdraw principal or unpaid instalments certain in advance may be permitted by contract provision and should be permitted under the Interest Option in all cases. When permitted, a special limitation usually is included by which payment may be deferred for a period of two or three months following written request therefor to forestall an overwhelming demand for payment, although in practice this requirement need not be enforced by the company except in times of special emergency. Usually the rider does not permit limited withdrawals but requires that the entire proceeds be withdrawn at one time. If limited withdrawals are allowed either by contract provision or in practice, a definite restriction should be placed upon the minimum partial withdrawal that may be made or the frequency of such withdrawals.[19]

By the provisions of the rider the income under all options must be paid in equal periodical instalments either annually, semi-annually, quarterly or monthly. To elimi-

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[18] See surplus interest provision in connection with each option in Appendix B.1.

[19] See Clause 6 of Appendix B.1.

nate small accounts, the minimum amount that may be paid under an option is restricted, or the minimum periodical income is limited. A provision in the Settlement Option Rider is here recommended prohibiting an election pertaining to proceeds of less than $1,000.00 or providing an annual income of less than $10.00.[20]

Finally a provision should be included indicating the disposition of the fund in the event of the death of the payee while receiving income. It is not absolutely necessary to show here who the contingent payee is if this is stated in the supplementary contract covering the income settlement, and in the absence of any provision anywhere to the contrary, it seems reasonable and logical that the contingent payee be the payee's estate. It is, however, necessary to state in the Settlement Option Rider the basis of determining the exact amount payable.[21]

The Limited Income Options. Two of the standard options included in the policy provide for the periodical payment of equal instalments representing both principal and interest until the proceeds are exhausted. Under either of these options the entire proceeds and interest eventually will be paid.

The Fixed Period Option (Option 1 in Appendix B.1) definitely limits the period during which the income will be paid. The amount of the periodical income is determined by the amount of the proceeds and by the period during which the income will continue. This period usually is limited by contract provision to any number of years between one or two and twenty-five or thirty, although in rare instances provision may be included for payments during longer periods. The period selected must be a specified number of years and may not include a fraction of a year, so that, if monthly instalments are requested, the total number of monthly instalments payable must be a multiple of twelve. Each instalment represents a payment of interest accruing to date together with an additional

[20] See Clauses 7 and 8 of Appendix B.1.
[21] See Clause 9 of Appendix B.1.

withdrawal from the principal. The total of each instalment remains the same, but the portion representing interest and principal varies each time, so that the earlier instalments represent a larger payment of interest, whereas the later ones represent a more substantial withdrawal from the principal.

Under the Fixed Amount Option (Option 4 in Appendix B.1) the amount of each periodical payment is the determining factor rather than the period during which the income will be paid, as under the Fixed Period Option. The amount of proceeds available at the time the income is to commence will not affect the amount of periodical instalments, but rather the duration of payment. Each instalment represents a withdrawal from the principal fund, and interest periodically is added to any balance remaining on deposit.[22] The interest thus credited increases the period during which the instalments will be payable, and any surplus interest allowed extends this period still further. There need be no limitation upon the maximum income which may be paid under this option, as this would be determined by the amount of the proceeds, but it is wise to limit the minimum income. The general provision previously discussed[23] by which the annual income is limited is not adequate here, as in cases where the proceeds are substantial, the annual income requested might be less than the guaranteed interest on the proceeds, with the result that the fund would accumulate for an indefinite period. The minimum income should be limited by a special provision to an amount, at least, in excess of the guaranteed interest.[24]

Mathematically there is little, if any, difference between the two options. If the amount requested under the Fixed Amount Option were exactly that guaranteed under the

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[22] Many companies follow a more liberal practice than that set forth in Appendix B.1. by, in effect, computing interest at the time each instalment is paid rather than once a year.

[23] Clause 8 of Appendix B.1.

[24] It is the author's opinion that the 6% limitation imposed in Clause 5 of Appendix B.1. is unwarranted and imposes an unnecessary obstacle to life insurance programming.

Fixed Period Option for a specified number of years, the income would continue for that period provided no surplus interest were allowed. The allowance of surplus interest would increase the period under the Fixed Amount Option and would increase the amount of the instalments under the Fixed Period Option.

The Fixed Period Option is preferable if the period of time during which the income is to be paid is a more important factor than the amount of income to be received, and this option should be elected when the period of the income is the major consideration. For example, it is well adapted to providing funds for a college education, since the proceeds can be spread evenly over a period of exactly four years, the usual college course, while under the Fixed Amount Option it might stop too soon or continue too long. The Fixed Period Option would be particularly well suited to the very unusual situation where the estate of the insured is so arranged that a substantial periodical income will commence after a specified number of years following his death, since income under this option may be provided during the interim. This option also might be helpful in providing an income for the rearing of the policyholder's children, but when elected by the insured for the beneficiary at his death, he might find it difficult to know the proper period to select, and frequent revision is advised. The Fixed Period Option is probably most frequently used to provide a temporary income during the period of readjustment following the insured's death.

The Fixed Amount Option, on the other hand, is preferable when the amount of income is the more important factor. It is useful for providing income for rearing and educating children, and is well suited for providing income during the adjustment period following the insured's death. Through changes from time to time in the amount of the income it can be used to augment and level off the income provided by social security. It is particularly well adapted to settlements of small insurance estates, as the amount of income will be sufficiently large to be beneficial, a situation that is unlikely under any other option.

If under the Fixed Amount Option additional partial withdrawals from the principal are permitted, this option can be used to provide a more flexible income to correspond with the changing needs of the beneficiary. This can be achieved by providing for payment under this option of the minimum income required by the beneficiary for living expenses, with a limited additional withdrawal privilege up to the maximum amount required, so that the payee may augment her annual income to the extent that is necessary. It must be remembered under this plan, however, that the entire proceeds ultimately will be exhausted and the income will cease, and that each additional withdrawal from the principal hastens the date that this will occur.

The Fixed Period Option lacks flexibility. It is intended that once it has been elected it should continue until the end of the period without subsequent alteration. It does not permit increase or decrease in the income at any time, nor does it lend itself readily to partial withdrawals or commutation. The periodical instalments, representing as they do interest and principal payments, do not lend themselves readily to variations in amount. To provide for unforeseen emergency, the payee might be given the right to receive in a single sum the commuted value of all future instalments, but a partial commutation reducing the amount of future instalments would be an involved procedure and one which the company would prefer not to undertake. A further disadvantage of this option is that it does not fit in with any settlement involving subsequent changes to another option, as it is assumed under this option that the income will continue without subsequent change throughout the period.

The Fixed Amount Option, on the other hand, is well adapted to meeting all of these situations. Because it represents merely a periodical withdrawal from the principal, the amount of such withdrawals may be increased or decreased from time to time without affecting the mechanical operation of the option, the interest being credited only upon the balance. For the same reason, withdrawals from the principal in addition to the periodical income could be allowed freely, and such withdrawals, if made, would merely shorten the income period. Finally, this option is well suited to subsequent changes to other options, since the income could be continued during a specified period, at the end of which any balance remaining on deposit could be applied under another option. The Fixed Amount Option is extremely flexible; in fact, it is the most flexible of all the options.

Generally speaking, the Fixed Period Option should be more satisfactory when elected by the payee after maturity, while the Fixed Amount Option should be more satisfactory when elected by the insured prior to maturity. Under the Fixed Period Option the beneficiary knows exactly when the income will terminate and can plan accordingly well in advance, while under the Fixed Amount Option the policyholder knows the amount of periodical income that the beneficiary will receive. Because of its extreme flexibility, the Fixed Amount Option usually is preferred, the Fixed Period Option being better suited only to post-maturity election where future changes probably will not be desired.

Neither option should be elected if a permanent income is desired, since neither option will achieve more than to disburse the proceeds as income over a period of years. When a life income or an income of indefinite duration is desired, the Life Income or Interest Options are recommended.

The Instalment Bond Option. Another settlement option which may be designated as the Instalment Bond Option, similar in many respects to the limited income options, is offered in some instances. This option is similar to the Fixed Period Option except that a single sum of substantial amount is paid at the end of the income period, so that the option involves merely a combination of the Fixed Period Option with a deferred single sum payment. The number of years during which it operates are usually limited to ten, fifteen or twenty. Though variations may exist, it usually is so arranged that the monthly income is exactly 1% of the single sum payment.

This option operates in the same manner as the Fixed Period Option and is subject to many of its advantages and disadvantages, although additional flexibility is afforded by the single sum payment. This option's most frequent use is to provide income during a specified period with a deferred income of a lesser amount. Thus the option can be used to provide an income while the children are growing with a subsequent life income to the mother thereafter, a similar settlement to that under the Family Income Policy to be discussed in the next chapter.

This arrangement may be achieved by placing the single sum payment under another settlement option. There is no real justification for the single sum payment at the end of the income period unless it is used in this manner. The only possible justification for payment to the beneficiary in a single sum might lie in the dubious contention that she could invest this fund more wisely after several years of experience with finances than she could immediately following the insured's death, or that in the light of changed conditions she would know how to put it to better use than would the insured prior to his death.

The Life Income Options. The Life Income Option (Option #2 in Appendix B.1) provides for the payment of periodical income during the lifetime of the payee with instalments guaranteed during a specified period. A selection is allowed as to the guaranteed period during which instalments certain shall be paid, though the number of choices usually is limited to only such periods as five, ten, fifteen, or twenty years. Some companies allow in addition a Life Income Option with no certain period, or a guarantee of the continuation of the instalments until their total equals the original proceeds. Surplus interest may be allowed under this option, but, if so, should be limited to the certain period.

The purpose of providing for the payment of guaranteed instalments is to preserve a portion of the proceeds should the payee die prematurely. A Life Income Option without a certain period would result in the loss of almost all of the proceeds should the payee die prematurely. A Life Income Option without a certain period would result in the loss of almost all of the proceeds should the payee die shortly after maturity.

The periodical income is determined by the age and sex of the payee, the certain period desired, and the amount of the proceeds. The periodical income that the beneficiary will receive at the insured's death under this option cannot be predicted in advance, even though it is assumed that the amount of the insurance proceeds can be predicted. Except at the older ages, the income under this option is small, so that a substantial amount of insurance is required to provide an adequate income to live on. Unless income from other sources is available to the beneficiary, this option is not recommended when the insurance estate is small.

This option is designed for the sole purpose of guaranteeing a life income to a person who is wholly dependent upon the insured for his or her support. The smaller the number of certain instalments, the larger the income will be, although often at the younger ages this difference is not appreciable. If the policyholder is interested primarily in providing a life income for the primary beneficiary and has no particular interest in preserving the funds for the contingent beneficiary, he should elect the smallest number of certain instalments available. If, on the other hand, the policyholder wishes to preserve a portion of the funds for the contingent beneficiary should the primary beneficiary die prematurely, he should elect instalments certain for the maximum period available. For example, should the insured wish to provide a life income for his wife yet be assured that the income will continue until his children are grown, this result could be achieved by electing the Life Income Option payable for twenty years certain, but, should there be no children or other dependents, a larger income could be provided for the wife or the same income could be procured from a smaller policy, were it payable for five or ten years certain instead.

One should exercise care in distributing the proceeds between two payees to be paid under the Life Income Option for single lives. If the fund is divided evenly between the two, it will not provide a similar income for each beneficiary unless they are of the same age and sex. The proceeds in such instances should be so apportioned as to provide approximately equal incomes for each person.

A variation of the Life Income Option is to be found in the Joint and Survivorship Option, previously mentioned, which provides for a life income during two lives. This option may apply to the insured and the primary beneficiary upon maturity as an endowment or upon surrender of the policy for its cash value, or to two beneficiaries at the insured's death. In some cases the option provides for a reduction of the income when one of the beneficiaries dies, while others provide for continuation of the same income during the lifetime of the survivor. During their joint lifetime, the income may be paid jointly to the payees or solely to that one who makes the election, and thereafter to the survivor.

Before electing the Joint and Survivorship Option, due consideration should be given to the mathematical aspect of the case, since in some instances it may be preferable to divide the funds between two beneficiaries, each to receive under the Life Income Option for single lives. Under this latter plan the death of one of the beneficiaries would diminish the income of the survivor after the certain period, while under the Joint and Survivorship Option the income during the joint lifetime of both payees is less. As a general rule, if the basis for calculating both options is the same, a more satisfactory income may be obtained by dividing the fund if there is a vast difference between the ages of the two payees, while the Joint and Survivorship Option may prove preferable when the two beneficiaries are of very nearly the same age. Sometimes a satisfactory result can be achieved by apportioning the fund between the two plans.

The Life Income Options, both the single and the Joint and Survivorship, provide a type of settlement that is not available under any other settlement option and one that could not be obtained through arrangement with any financial institution other than a life insurance company. None of the other settlement options involve life contingencies, and a trust company is not equipped to administer to a beneficiary under a trust a guaranteed life income which would dissipate both the principal and the interest. These options have no flexibility and do not permit variations in the amount of income, emergency withdrawals, or subsequent settlement under another option, but when the primary and only purpose of the policyholder or payee is to provide or obtain the largest possible income that will be guaranteed for life, the Life Income Options are well suited.

The Interest Option. The Interest Option (Option #3 in Appendix B.1) provides for retention of the entire proceeds, and interest thereon at a guaranteed rate is paid in periodical instalments. The principal usually may be withdrawn upon demand subject to a prescribed waiting period. Although the income provided under this option is considerably smaller than that payable under any of the other options, this disadvantage is offset by the retention of the entire principal fund intact. Because of this factor it night be wise to insert in the option a provision limiting he maximum period of retention. The retention of the proceeds, even for a limited period, renders this option the most suitable for several types of settlement.

It may be used to conserve the proceeds for payment under one of the other options at a later date. The insured may have other assets which would provide an adequate income for his dependents in the years immediately following his death, or the need for a greater income may not arise until several years thereafter. If the insured's family will receive a pension from his employer for a limited period following his death, it may not be necessary to use the insurance proceeds until after the pension has ceased. If his wife is working or has a profession she can turn to, she may not require the income from his insurance until she reaches retirement age. In the former instance retention at interest during the pension period and then one of the limited period of life income options is suggested, while in the latter retention at interest to age 60 followed by the Life Income Option seems logical.

The preservation of the proceeds for future use is desirable when the insurance is to be used entirely for educational purposes. The greatest expense occurs during the years the children are attending college, so that, should the insured die while his children are still very young, it may be well to set aside a fund to be preserved for this purpose. This can be achieved by retention under the Interest Option until the children are of college age, at which time the proceeds may be paid under one of the limited income options or a withdrawal privilege may be granted.

The Interest Option may be used to conserve the insurance estate. In the case of a wealthy individual who has provided adequate income from other sources for his immediate dependents, the entire proceeds may be held at interest without withdrawal rights throughout the lifetime of his wife and thereafter as long as the company will permit for his children. In this way a small life income is provided for the wife and the estate is held intact. Caution is advised, however, in recommending such a settlement to a policyholder, as the lack of flexibility may prove a burden to the beneficiaries should the family fortunes be seriously reduced. Certainly it should be supplemented by a substantial income from other insurance.

Another use of the Interest Option is to preserve the proceeds for unforeseen emergencies. To achieve this a small amount may be left with the company at interest, subject to withdrawal upon demand, or a larger amount may be left at interest subject to a limited or deferred withdrawal privilege. This permits a sound investment that will be available when needed for some future contingency. As stated before, the programming of a life insurance estate should not be undertaken without providing such a fund.

Finally, the Interest Option may be used to provide a limited but flexible income. This may be achieved by leaving the proceeds at interest subject to a limited annual withdrawal privilege, the beneficiary drawing from the principal only such amount as is needed with any excess invested for future use. This plan is less rigid than the one suggested under the Fixed Amount Option in that the entire principal may be conserved should the beneficiary have sufficient income from other sources. The exact amount required for future expenses cannot be determined in advance, as they will be subject to fluctuating economic, social and personal conditions. This plan is of disadvantage only in that it imposes upon the payee greater responsibility in budgeting the use of proceeds, as frequent small withdrawals probably would not be permitted by the company, so that income at frequent intervals is not available. It imposes upon the company a greater burden in administering the account.

The Interest Option is a very popular one. It is extremely flexible and lends itself readily to all manner of irregular settlements. Through retention of the proceeds intact it provides an excellent means of investment. Through the withdrawal privilege it permits flexibility of income. Finally, it enables future use of the proceeds or a portion thereof through settlement either in cash or under one of the other options.

Education Settlements. We have already mentioned the fact that several of the options are suitable for providing for the college education of the insured's children. There are several different plans by which this end may be accomplished, each of which has its relative advantages and disadvantages.

One plan involves exclusive use of the Fixed Amount Option with the income increasing as the child grows older. A nominal income is provided during the years of childhood with a moderate increase during the higher grades, a further increase during the high school years and a substantial increase to cover the increased expenses of a college education. Interest income may be sufficient during the years of childhood followed by a monthly income of

$25.00 during the higher grades (approximately after age 9), of $50.00 during high school (approximately after age 13) and $100.00 during college (approximately after age 17). The rate of income should change during September to conform with the new school year. Greater flexibility can be achieved by giving the insured's wife or some other responsible party the right to direct when the high school and college incomes shall commence so that they will conform more nearly with the actual scholastic experience of the beneficiary. This plan is of advantage in that it neatly provides for the entire education of the child, but a substantial amount of insurance is required and the program will be curtailed before it has been completed if the insurance is reduced by outstanding indebtedness.

Because of the fact that most schools and colleges have vacation during the summer months and that extra heavy tuition expenses are due at the beginning of each semester, a level monthly income throughout the year is not well adapted to meeting education expenses. If the company will permit it, an alternate plan is suggested by which the instalments under the Fixed Amount Option are eliminated altogether during the summer months while additional instalments are payable during the months of September and February, the months in which tuition in most colleges is payable.[25] While the advantages of this plan are obvious, it is equally obvious that it would lose its point altogether should the institution of learning selected by the beneficiary not conform to the usual standards regarding the payment of tuition and vacations.

Where the purpose of the settlement is to cover college education only, we have already mentioned the advantages of the Fixed Period Option. The proceeds may be retained at interest until college age and then paid in instalments for four years. This plan is of advantage in that the proceeds are evenly distributed throughout the college years regardless of the amount, but, except for this one feature, this plan is lacking in flexibility.

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[25] See further discussion on pages 72-73.

A final plan involves the exclusive use of the Interest Option with the right to make limited withdrawals during the college years. This plan is of advantage in that funds are available to the extent and at the time they are needed while the total fund cannot be exhausted regardless of its amount before the college course is completed. The disadvantages of this plan are that the income is spasmodic and not at regular intervals, while the mechanics of making withdrawals might be complicated owing to the fact that the beneficiary is a minor.

Under education settlements it is essential to give consideration to the payee as well as to the plan of settlement, a fact not often recognized by life insurance agents. The fact that the beneficiary is a minor complicates the situation. This problem will be discussed at length in another chapter.[26]

[26] See discussion of settlement with minors beginning on pages 68-70.

CHAPTER II

INCOME POLICIES AND ANNUITIES

Long before the Settlement Option Rider was devised policies were issued which were payable in the form of income instead of in a single sum. The subsequent inclusion of the Settlement Option Rider did not eliminate completely the use of these policies, and even today, when settlement options are included in all standard policies, most companies still issue special income policies.

The advantages of such policies over single sum policies are twofold. Special programs which could not be accomplished through the use of the settlement options might be arranged through this means, and, being more understandable to the applicant and to the soliciting agent, the income policies are more easily sold.

It is difficult for the policyholder to plan an income which will be adequate to take care of his children until they become self-supporting since the period during which the income is desired is determined by the date of the insured's death, and the earlier his death the larger will be the amount of insurance required for this purpose. When the policyholder wishes to provide a life income for the primary beneficiary, he cannot determine exactly the income that will be provided under the Life Income Option at his death, for the longer the insured lives the larger the income will be. As a result, two of the major purposes of life insurance, the rearing of children and the providing of life income for dependents, is not always achieved most effectively through the use of settlement options. Arrangements requiring a changing amount of insurance with the passage of time can be worked out best through the use of special plans of insurance.

These special policies have an added advantage in that the determining factor is the income payable to the beneficiary and not the face amount of insurance. Through the stressing of income instead of face amount, they often are more readily sold. They are more easily understood both by the applicant and by the agent than single sum policies paid under settlement options.

The income policies have the disadvantage of lacking flexibility. They are devised to serve only one end and cannot be used for other purposes. It usually is necessary that these policies be issued in fairly substantial amounts, so that, if the insured already has considerable protection he may not be able to afford an additional income policy even for the minimum amount that the company will issue on that plan.

The Family Income Policy. A combination of a substantial income before the children are self-supporting and thereafter a life income for the wife can be achieved through the use of the Family Income Policy. By the provisions of this policy [27] the face amount is payable upon a specified date should the insured die prior thereto instead of upon the insured's death, and during the interim between the insured's death and the payment of the face amount a monthly income of one percent of the face is paid. The face amount when payable may be paid under any of the regular settlement options in the policy. The date upon which the face amount is payable is usually set at twenty, fifteen or ten years from the date of issuance. Should the insured live beyond this period, the face amount is payable immediately upon his death, and the annual premium is reduced to the regular Ordinary Life premium after the income period has expired. This policy, in effect, is an Ordinary Life Policy combined with level premium reducing term insurance.

By this plan the insured has provided a definite income which will continue until the date his children are self-supporting, at which time the single sum payment then due

[27] The policy described here has various modifications as to its name and provisions, depending upon the company involved. It may be called, for example, the Family Maintenance or Family Protection policy.

may be used to provide income for his wife under the Life Income Option, or under one of the other settlement options in the policy, if preferred. This plan is of definite advantage in this connection in that the policyholder knows the exact amount of income that will be paid. He knows that no matter when he may die, a definite income will be paid to his children until they are grown. Likewise, he knows the amount of income that will be available thereafter to his wife under the Life Income Option, since he knows what her age will be when the single sum will become payable. This plan offers some degree of flexibility, since the face amount when payable need not be applied under the Life Income Option, although such application would seem most logical, but may be applied under any of the other settlement options in the policy or even paid in a single sum. Of course, this reasoning would not apply after the expiration of the income period when the policy would become an Ordinary Life Policy, but in that instance the insured would have outlived the purpose of the insurance which then should be applied toward other uses.

A similar arrangement could not be achieved so economically through the application of the settlement options to single sum policies. It would require considerable insurance to provide adequate income under one of the limited income options to raise children who are very young, but as they grew older less and less insurance would be required for this purpose, so that some of the insurance originally carried would become superfluous. By combining reducing term insurance with Ordinary Life, the Family Income Plan enables the policyholder to carry out this program at the minimum premium outlay.

Because of the reducing term feature of this plan, it is feasible for mortgage protection. If the insured has a ten, fifteen or twenty year mortgage on his home which he is gradually retiring by equal periodical payments, a Family Income policy could be used to help pay any remaining instalments in the event of the insured's premature death, so that the mortgage would be retired on schedule. Owing to the inflexibility of the Family Income Policy and its deferred single sum settlement, however, it is questionable whether an income arrangement is feasible. When used for mortgage protection, it is probably preferable that the policy be endorsed for payment of its commuted value in a single sum. If the amount of the policy were sufficient, it could be arranged so that the reducing term feature would roughly equal the balance due on the mortgage, while the ordinary life feature would afford substantial protection for the family.

The disadvantage of the Family Income policy lies primarily in the fact that it is not always thoroughly understood. The amount of insurance is steadily decreasing while the premium remains the same during the income period, a feature that is unpopular with some policyholders. This feature introduces a possible element of selection against the company on the part of the applicant.

The Family Income settlement is very similar to the Instalment Bond Option previously discussed, the only difference being that the income under the Family Income Policy ceases upon a specified date instead of after a stated number of years. To meet the reducing insurance objection to the Family Income Policy, many companies use an application of the Instalment Bond Option by issuing an income policy providing for the payment of income for twenty years followed by the payment of the face amount should the insured die within twenty years after issue.[28] Should the insured survive the twenty year period the face amount is payable immediately. This policy is a combination of permanent insurance to take care of the face amount and twenty year term to take care of the income, but may be endorsed to provide for payment of its commuted value in a single sum. Notwithstanding the questionable economic justification for this type of policy as opposed to the Family Income and notwithstanding the slight additional premium required, this plan has actually proved more popular because the amount of insurance remains constant throughout the term and because it is more easily understood.

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[28] This policy also may be issued in units for ten or fifteen years.

The Continuous Instalment Policy. In order to overcome the uncertainty as to the amount of income that will be paid to the beneficiary under the Life Income Option, many companies have issued special income plans of insurance often referred to as Continuous Instalment Policies. The advantage of this plan is that the policyholder may provide a definite life income for a dependent beneficiary at the minimum cost.

This plan of insurance provides for payment, commencing upon the insured's death, of a definite amount of income to the primary beneficiary during her lifetime with a specified number of instalments certain, usually either ten or twenty. Under this policy the amount of the monthly income instead of the face amount of insurance is the determining factor. The amount of insurance is roughly the amount required for the Life Income Option at the beneficiary's attained age. Since as the beneficiary grows older a lesser amount is required to produce the deferred annuity, the policy is one of steadily reducing amount and is in effect a regular Ordinary Life Policy in the amount of the commuted value of the instalments certain combined with a level premium reducing term policy of prolonged duration to provide a fund for the deferred annuity. The required amount of insurance under this plan is determined by the beneficiary's date of birth.

The primary disadvantage of this plan lies in its lack of flexibility, not only with reference to the income feature, but with reference to the beneficiary designation as well. Should the policyholder wish to change the beneficiary or the plan of payment, or should the beneficiary die, it is necessary first to terminate the deferred annuity feature in the policy with a compensating reduction in the premium, so that the insurance protection for the newly designated beneficiary amounts to only the instalments certain or their commuted value. This policy is entirely for the benefit of one individual, and because of its lack of flexibility in this respect, it has not been very popular.

Annuities. Life insurance companies are authorized by law to issue both life insurance policies and annuities. Under the latter type of policy the applicant pays the insurer a substantial sum in return for which the insurer agrees to pay a guaranteed periodical income as long as the insured, or annuitant as he is called under this form of contract, lives. Mathematically annuities are the reverse of life insurance in that the face amount is paid by the applicant in advance while the periodical instalments are paid by the insurer. Socially they differ from life insurance in that an annuity guarantees to the insured an income during his lifetime whereas life insurance guarantees a continuation of his income, in part, at least, after his death. One insures against premature death; the other against prolonged life.

In the years following the depression of 1929 annuities became extremely popular, since most disillusioned investors felt that they afforded the safest investment available. An annuity is a desirable form of investment in that a specified income is guaranteed for life. Its disadvantage as an investment is the ultimate complete dissipation of the principal. Annuities afford a good investment for people of means who need a life income but need not preserve the principal for their heirs. Under this form of contract they can use up their principal without fear of poverty when it has been exhausted.

The annuity business has not been an entirely profitable one for the life insurance companies, with the result that it has been found necessary from time to time to increase the rates substantially. The company does not select the risk for annuity insurance, as it does in the case of life insurance, and policies are offered to all applicants quite freely. Although the applicant cannot predict the future duration of the annuitant's lifetime, annuities usually are applied for by individuals who are in the best of health. Furthermore, the security afforded by an annuity appears definitely to prolong life.

There are many types of annuities. Generally speaking, they resolve themselves into two classifications, immediate and deferred annuities. Immediate annuities may be classified as to the nature of the instalments certain, if any are allowed, and as to the number of lives involved. Deferred annuities may be classified as to the method of premium settlement and the date of maturity.

There are several kinds of immediate annuities. The Life Annuity provides for no payment of instalments certain, so that should the annuitant die shortly after the policy has become effective, further payment by the insurer ceases altogether. The Refund Annuity provides that on the annuitant's death instalments will continue to the beneficiary until the total instalments paid the annuitant and beneficiary together equal the single premium, so that under this plan the older the applicant the shorter will be the period for payment of instalments certain.[29] Another kind of immediate annuity provides for payment of instalments during a stipulated number of years and for life thereafter regardless of the size of the income and is, in effect, equivalent to the Life Income Settlement Option. A further variation of the Refund Annuity Policy occasionally encountered is the so-called Cash Refund Annuity which provides for payment in a single sum at the annuitant's death of the difference between the premium and the instalments already paid instead of the continuation of the instalments as is done under the regular Refund Annuity.

The Refund Annuity has the advantage of guaranteeing to the annuitant that a portion of his investment will be returned should he die prematurely, whereas the Life Annuity has the advantage of providing a larger income, but under the latter form of contract the early death of the annuitant results in practically the entire loss of his investment, a situation that is not viewed favorably by his heirs. In practice, the Life Annuity is desirable only when the policyholder has no desire to preserve any portion of the investment for himself or his heirs.

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[29] If the balance of the instalments are commuted and paid to the beneficiary in one sum, the total payments actually will be less than the original cost.

Annuities may involve the payment of income depending upon one life or upon two or even more lives. Annuities involving two or more are called Joint and Survivorship Annuities. The income under this plan is continued until the survivor of the annuitants dies, although some plans may provide that it decrease upon each successive death. If the applicant has a lifetime dependent such as a spouse or parent, the Joint and Survivorship Annuity will take care of him and such dependent as long as they live. In determining whether the Joint and Survivorship Annuity is preferable to Single Life Annuities on each life, the considerations are much the same as those discussed in the preceding chapter with reference to the choice between the Joint and Survivorship and the Single Life Income Settlement Options.

Deferred annuities provide that the income, instead of commencing immediately, shall commence at a later date. Their usual purpose is to provide a life income at retirement. These policies can be written upon the single premium or upon the annual premium basis, the latter being the more popular, since in this way the annuitant may set aside a portion of his annual earnings to provide a life income when he is compelled to retire from active business. This plan often is used in conjunction with pension trusts.

The policy usually provides for automatic maturity as an annuity when the insured attains the age of 60 or 65 years, although maturity at other ages may be provided, and some plans have no automatic maturity provision whatsoever, but permit the annuitant to elect an annuity at any time. The latter type of deferred annuity is, in effect, little more than a periodical deposit with the insurer to be applied toward the purchase of an immediate annuity at some indefinite future date.

Deferred annuities and life insurance may be combined in one policy, an endowment payable under the Life Income Settlement Option at maturity being an example. In order to provide a more adequate income at maturity, special endowments or annuity policies have been issued which provide for a definite relationship between the face amount of insurance and the monthly annuity available at maturity. An adjustment in the reserve may be necessary in order that the proceeds at maturity may be sufficient to provide an income that may be stated in round numbers.

Prior to maturity deferred annuities are very similar to life insurance policies, and practically all of the provisions of life insurance policies can be made to apply. Immediate annuities, on the other hand, differ considerably, but the contract in form resembles somewhat the life insurance policy.

Under immediate annuities the policy privileges are extremely limited. It is intended that once payments have commenced they should continue throughout the annuitant's lifetime without subsequent alteration. With the payment of the single premium, the obligation of the applicant is fully discharged. The reserve maintained for future payments could not be made available to the policyholder, as such procedure would permit tremendous selection against the company.

Annuity policies usually are non-participating, although under some contracts dividends representing surplus interest earnings may be allowed. A mortality dividend is not feasible, because the annuitants who die are the ones who contribute to the surplus resulting from this source.

The annuity policy on the whole is a rather inflexible contract. The Refund Annuity may confer upon the annuitant the right to commute unpaid instalments certain. Also, under these contracts, a beneficiary may be designated to receive any instalments that are due at the annuitant's death.

Pension Trusts. In line with modern trends most corporations and large businesses are forced to acknowledge the principle that the employer owes to the employee certain considerations that were not previously recognized. Among these is the obligation to contribute toward the support of the families of those employees who may die prematurely and to provide for those employees who have given many years of faithful service but who through old age have passed their period of greatest usefulness. Most progressive corporations have for years maintained some sort of a pension plan for their employees, but such plans have not proven entirely satisfactory because they were controlled entirely by management, the employees having little, if any, voice in their administration and no guarantee, beyond the employer's word, of their ultimate realization. They were of further disadvantage in that adequate reserves were not maintained to meet future obligations or, if they were, the management assumed full responsibility for the investment of the necessary funds to achieve this.

To offset these disadvantages it has been found preferable to have the employees' benefits administered through a separate trust commonly called a *pension trust.* The trustee may be a committee selected from among the officers and employees of the corporation or it may be an independent trust company. The employer makes annual contributions to the trustee who in turn accumulates, invests and disburses these funds in accordance with the trust agreement. If the employees participate in the contributions, it is called a *contributory plan*; if the contributions are made solely by the corporation, it is called a *non-contributory plan.*

Life insurance contracts have proven the best adapted investment for pension funds. Under life insurance policies future values are guaranteed in advance and are not subject to speculative hazards, while investment and reinvestment problems are eliminated. The program is easily administered, as the burden of administration is borne by the life insurance companies, who are well equipped to bear it. Finally, life insurance policies are perfectly suited for the pension trust benefits, as it is their function to insure against premature death or provide a retirement income in the event of prolonged life. In fact, as we have already seen, life insurance policies, through the Life Income Settlement Option and through the various plans of annuities that are available, are the only means of providing a definite and guaranteed retirement income of lifelong duration.

Individual standard policies may be purchased under the trust or the entire group may be covered by one group policy. Where individual policies are purchased the Annual Premium Deferred Annuity is best suited when the pension plan calls for retirement benefits only, while a combined long term endowment with retirement annuity benefits is best suited when the plan calls for life insurance benefits as well. Group policies are preferable to individual plans in that the premium cost is reduced, the protection can be extended to risks who might be uninsurable under individual plans and the overall plan is more easily administered. They are of disadvantage in that their provisions are not so comprehensive so that they lack the flexibility of individual policies, they do not afford full protection to those employees whom it is desired to insure more heavily, it is not available where the number of employees is small and the rate is not guaranteed but is subject to subsequent readjustment. This latter objection has been offset through the introduction of the Group Permanent Plan under which ordinary life policies with standard cash values are issued on each life.

Through statutory provisions and increased usage the form and provisions of the Pension Trust Agreement have become somewhat standardized. Since the agreement must of necessity be extensive, it is to be hoped in time it will become so standardized in form that its provisions may be easily ascertained without exhaustive study. In general, the agreement includes the name of the trust and the trustees, the employees entitled to participate and the extent of their participation, the manner in which contributions to the trustee shall be made, the retirement date and benefits, the death benefits, if any, the disposition in the event employment is terminated, the powers of the trustee and the pension committee, if any, and the relationship between the trustee and the insurance company. Of these the insurance company is concerned mainly with the retirement and death benefits, the powers of the trustee and the relationship with the insurance company. The insurer's concern with the death and retirement benefits is obvious;

its concern with the powers of the trustee are to determine who is authorized to sign applications for new policies and to apply for benefits under policies already in force.[30] The policies when issued should not confer upon the trustee more privileges than are granted under the trust, while if any benefits are available to the insured employee directly, the policy should so recite. Finally, no insurance company should issue policies in conjunction with a pension trust agreement unless the agreement specifically recites that the insurance company is not a party to the trust and is not responsible for any act which it or a trustee may perform that is not in accordance with the provisions of the trust. Aside from the obvious legal issues, the insurer will find it easier and more practical to administer the policies under the trust if in so doing it may be guided wholly by the terms of its own policies.[31]

One of the objections to the use of life insurance policies under pension trusts is that they lack flexibility in that through the requirement that annual premiums be paid when due to continue the policies in full force, the whole plan may break down and valuable funds be sacrificed, should the employer, in a year of economic reverses, be unable to meet the required premium outlay. To meet this objection, what is called the *stop and go* provision may be added to policies which are issued in connection with pension trusts. By this provision premium payments may be temporarily suspended and the policy reserve allowed to accumulate at interest until premium payments are resumed, when the policy may be restored to full force upon an adjusted basis.[32]

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[30] The right to change the beneficiary and elect a settlement option may be reserved solely to the insured or solely to the trustee or to the two jointly. Generally the insurer may rely upon the provisions of the policies in this respect, but a subsequent amendment to the trust might be contrary to the provisions in those policies already issued.

[31] See Appendix A.5.

[32] During the period of suspension the Company is liable only for the surrender value and interest thereon, and when the policy is reinstated, the valuation date and age at issue are moved up for a period equivalent to the period of suspension, and the amount of insurance is adjusted to that which the available reserve would purchase in the new basis.

The pension trust has enjoyed enormous popularity in recent years. It has proved of advantage to employers and employees in that it has increased morale and good will, has stabilized employment by reducing turnover, increased the efficiency of operation through the retirement of aged and inefficient personnel, has relieved employees of financial fear and has improved public relations generally. The prime advantage to the employer, however, is that the payments so made may be deducted in computing corporation income taxes. In years of excessive corporate taxes such as prevailed during World War II, the benefits listed above may be obtained at a negligible cost. It is feared by the insurance companies that when corporate taxes are reduced many of these plans will cease to operate. This danger can be offset only by careful selection by life insurance companies and careful presentation of the plan by life insurance agents.[33]

[33] An excellent anlysis of pension trusts was prepared by the editorial staff of the Insurance Research and Review Service of Indianapolis, Indiana, and published in 1943 under the title "A Study of Pension and Other Employees Trusts."

CHAPTER III

SUPPLEMENTARY CONTRACT PROCEDURE

When, following the maturity of a policy, its proceeds are retained by the company to be paid as income under a settlement option instead of in a single sum, a Supplementary Contract is created. Except in the case of income policies, the contract is terminated entirely upon maturity, as all liability of the company ceases upon payment of the maturity proceeds. Although by the provisions of the Settlement Option Rider the proceeds need not be taken by the payee at once but may be left the company to be administered under a settlement option, the insurer, nevertheless, is immediately liable for the entire maturity proceeds. The settlement option privilege, like the Nonforfeiture Option, is a continuing offer on the part of the company and does not become truly effective unless and until accepted by the owner of the policy or by the beneficiary, as the case may be, so that the election of a settlement option and the administration of the payments thereunder may be viewed as a separate contract.

The status of the Supplementary Contract might be clarified if we consider briefly the accounting procedure at maturity. Let us assume that at the death of the insured the beneficiary directs the company to retain the proceeds under the Interest Option. In this instance the death loss account is debited for the full face amount of the policy and the deposit account is credited for the same amount. The Annual Statement will show under Disbursements the payment of the full face of the policy as a death loss and under Income the receipt of this money to be administered under Supplementary Contract. Although the transaction may involve no payment of money at all, the accounting would be the same as would be the case had the insurer paid the beneficiary the death proceeds and at a later date the beneficiary paid the company the amount to be held.

Although the accounting procedure is the same, the legal aspect of the picture changes when we deal with policies such as the Family Income or Continuous Instalment policies discussed in the preceding chapter. Such policies, by their provisions, do not terminate upon maturity but are payable in instalments. The same situation prevails in the case of the deferred annuities and to a certain extent in the case of immediate annuities. In either case the income is not paid under a Supplementary Contract entered into with the company but instead is paid under the terms of the policy. Although theoretically such policies do not come under our definition of Supplementary Contracts, practically the ensuing discussion will apply in either case.

The legal aspect of the definition of Supplementary Contracts is probably not so important as the accounting aspect. The only legal question arising in this connection is the interpretation to be put upon the phrase "during the continuance of the policy" when used to limit the period of ownership. Although the question may be disputed, it has been held [34] that the phrase was intended to apply only to the endowment or life period and not to the Supplementary Contract. Under income policies it could be extended to cover the period during which the income was being paid, except that under the Family Income Policy, the policy could be considered as terminated upon the due date of the single sum payment, even though the single sum payment is to be paid under a settlement option.

The Conditions Governing the Creation of a Supplementary Contract. The essential factors in the creation of a Supplementary Contract are the conditions under which the settlement option applies, the election by the policyholder or payee, the issuance of the contract, and the accounting procedure involved. These factors will be discussed in this chapter.

The settlement options apply to proceeds payable upon the insured's death, upon maturity as an endowment, upon

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[34] Cox v. Cox (1915), 192 Ill. Appeals 286.

surrender of the policy for cash [35] and upon payment of the single sum under Family Income Policies. As we have seen the insured may direct that the proceeds payable upon his death shall be paid to the beneficiary under an option. If he neglects or does not choose to do this, the beneficiary may elect an option after the insured's death. The settlement option privilege also is available to the payee upon maturity as an endowment or upon surrender for cash. Prior to maturity as an endowment, the owner of the policy may direct that upon maturity the proceeds be held under a settlement option, although there appears to be little purpose for this latter procedure if done many years before maturity, as the settlement option privilege is always available and the policyholder may change his mind several times before his election possibly could become effective. On the other hand, an election prior to maturity is desirable as a tax avoidance measure, since there will be no income tax on the profit at maturity if the net proceeds are payable in the form of income.[36]

Under an income policy the election of a settlement option is unnecessary, except insofar as it pertains to the single sum payable under the Family Income Policy. It is not intended that the settlement option privilege be used to alter the mode of payment of income as provided under an income policy. For example, the settlement option privilege should not be used to provide under a Continuous Instalment Policy that the instalments certain shall be commuted and retained under the Interest Option during the lifetime of the beneficiary.

When the settlement option privilege does apply, question may arise as to the effective date of commencing the income payments. It appears quite obvious and often is specifically provided in the rider that the date of maturity is the effective date of the Supplementary Contract. The only difficulty in this connection would arise under a doubtful disappearance case or a missing-in-action war casualty

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[35] See Clause 1 of Appendix B.1.
[36] See Appendix A.6.

where the alleged date of death of the insured was uncertain.

When the election is not made until sometime following the date of death or maturity, the practice of permitting the accrual of income to be retroactive to the maturity date may be questioned if this point is not clearly covered by the provisions of the Settlement Option Rider. This brings us to the question of how long the settlement option privilege remains available. The Settlement Option Rider often is silent upon this point, although it obviously was not intended that the settlement option privilege expire immediately upon death or maturity, nor was it intended that it be extended indefinitely. Time always elapses between the insured's death and the settlement of the claim, and usually additional time is allowed the beneficiary or payee to decide which option is desired. The usual practice is to release the company's check in full settlement of the proceeds with the understanding that the beneficiary or payee may return it to be retained under an option.

Some definite limit should be placed upon the time allowed during which the check may be thus held. If all the transactions are completed by the beneficiary with reasonable promptness, there is little real objection to allowing the Supplementary Contract to become effective as of the date of the insured's death, but when final settlement or the subsequent election of the option has been delayed through no fault of the company, it seems hardly fair to expect the company to allow retroactive interest.[37] If final settlement has been delayed for as long as six months following the insured's death, the company should not be required to allow retroactive interest under the option elected. Likewise, when settlement has been effected promptly but the beneficiary holds the settlement check for a period of more than one month thereafter, the company should not be liable for interest prior to the date of reimbursement. The settlement option privilege should be considered as no

[37] See Appendix A.7.

longer available when, at the most, three months have elapsed following payment.

The Election of Settlement Option Agreement. The first step in the creation of a Supplementary Contract is the request or the election by the policyholder or by the electing payee. This is accomplished through the execution of a form prepared in the home office and submitted to the policyholder for signature. The terminology used with reference to this form differs depending upon the practices of the company involved; it may be called a Settlement Option Election, Agreement, Request, Authorization, Certificate or Amendment. Merely to be consistent we shall always refer to this form herein as the *Election of Settlement Option Agreement*, or, for the sake of brevity, the *Settlement Option Agreement*.[38]

The purpose of the Settlement Option Agreement is to set forth the option elected, the rate or period and mode of payment, the payee and any other miscellaneous provisions bearing upon the settlement. This form is not to be confused with the Supplementary Contract[39] itself, although it contains all the Supplementary Contract's essential provisions. When an election is made by the insured to become effective at his death,[40] the Settlement Option Agreement becomes effective immediately upon its execution, but the Supplementary Contract does not come into being until after the life insurance policy has been terminated. The Settlement Option Agreement merely relates the provisions to be incorporated therein and is the acceptance by the insured or beneficiary of the insurer's offer that the proceeds be retained under a settlement option.

When the insured requests that the benefits be paid to the beneficiary as income under a settlement option, the procedure is very similar to that followed when the beneficiary is changed. The policyholder must revoke any Beneficiary Designation or Settlement Option Election pre-

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[38] See Appendix A.8.

[39] See illustration Appendix B.2.

[40] Appendix B.3 is an illustration of one type of supplementary contract.

viously made and should reserve the right to revoke the election just completed and to exercise all other rights available under the policy, including the right to change the beneficiary. The policy prescribes the method in which the transaction is completed and the conditions under which the new agreement becomes effective. The Settlement Option Agreement is returned when signed to the home office to be recorded in the same manner as a Change of Beneficiary. Most companies require in addition that the policy be submitted to the home office for endorsement whereby the provisions of the Settlement Option Agreement are incorporated into the policy itself. When this practice is followed, the Settlement Option Agreement is similar to an amendment to the policy. In a few companies the policy endorsement is not required. The Settlement Option Agreement is acknowledged by the company and made a matter of record, one copy being filed in the home office and the other being sent to the policyholder to be attached to the policy.[41]

The Settlement Option Agreement is far more complicated than a simple change of beneficiary form. Not only does it usually include the beneficiary designation and the details with reference to the Settlement Option Election, but in addition it must cover all possible future contingencies. If several primary, contingent and even second contingent beneficiaries are named, and if the election involves more than one settlement option, there are numerous possible contingencies which must be covered. Much can be written with reference to the provisions incorporated in the agreement, and we shall require at least two chapters to treat this subject as thoroughly as it deserves. Chapters IV and V will be given over exclusively to this subject.

The preparation of the more complicated agreements is a task requiring skillful draftsmanship. The provisions of some agreements are very extensive, so that many clerical hours are required for their preparation. Because certain minor differences are to be found in each individual

[41] See Appendix A.9.

request, the practice has developed to write the entire agreement in each individual case. Much similarity, however, can be found among the majority of requests, so that with careful study a large degree of standardization is possible. To simplify the preparation of this form, some companies have found the auto-typist a satisfactory means of preparing the agreements, as the essential paragraphs required may be selected and typed automatically, the individual data such as the names of the beneficiaries, etc., being typed by hand.[42] Other companies have found it possible to use printed forms which recite all the general provisions with only a minimum of individual data being entered by hand.[43]

When the request is not submitted until after maturity, the Settlement Option Agreement is simplified considerably, a mere written request from the payee often sufficing. When required, it often may be similar in appearance to the Supplementary Contract form and be retained by the insurer as its copy.[44] When more involved, it then must resemble more the form executed in conjunction with an election prior to maturity, although many of the provisions of the latter would not apply.

Physical Aspects of the Supplementary Contract. Upon death or maturity, except in the case of income policies, the policy terminates, and the Supplementary Contract then becomes effective. There are two methods by which the life insurance policy may be converted to the Supplementary Contract: the policy may be endorsed to show that it has been terminated by death or maturity,[45] or the policy may be taken up and a new Supplementary Contract issued in its stead.

The endorsement procedure is subject to many of the general disadvantages of policy endorsements.[46] The pro-

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[42] See "Preparation of Standard Forms of Optional Settlements," by Robert J. Lawthers; L. O. M. A. (1938), 92-102.

[43] Note items that must be entered in Appendix B.2.

[44] The payee should sign a duplicate of the form illustrated in Appendix B.3 to elect the option.

[45] See Appendix A.10.

[46] See Appendix A.9.

cedure is of further disadvantage in that it compels the payee to retain a bulky document, most of the provisions of which do not apply. The only policy provisions that do continue to apply are the provisions of the Settlement Option Rider, and here it is only as regards that particular option elected. Furthermore, there is the danger under this arrangement that the continued retention of the policy might be construed by the payee to mean that at a subsequent date he could avail himself of one of the other settlement options therein, a privilege that the insurer may not have intended to confer.[47]

This method may be obligatory if the provisions of the Settlement Option Agreement have been endorsed upon the policy as an amendment thereto. Also, under income policies, it is obligatory, as the income is paid under the policy provisions and not under the provisions of a Supplementary Contract, except that under the Family Income Policy the policy may be considered as terminating and a Supplementary Contract as commencing upon payment of the face amount, if the face amount is to be paid under a settlement option.

When the Settlement Option Agreement has been recorded without endorsement upon the policy or when the election is made after death or maturity, there is little justification for endorsing the policy, as a simple Supplementary Contract form will cover all the essential provisions of the agreement. This form is a brief document incorporated in which are the essential provisions pertaining to the settlement. If the provisions of the Settlement Option Agreement are complex, it may be attached to the Supplementary Contract or incorporated therein. This latter procedure is best in conjunction with all cases where the election was made prior to maturity and in all complicated post maturity elections.

The Supplementary Contract form is very simple if the Settlement Option Agreement is attached. This form includes the policy number and the name of the insured for

[47] See discussion of changes in options, pages 74-77.

identification, the amount of the proceeds, the income payable, the accrual date and the payee, to describe briefly the nature of the transaction, and a statement that the proceeds thus described will be administered in accordance with the provisions of the Election of Settlement Option Agreement which is attached and which is identified by the date of its execution.[48]

In the case of simple elections after maturity it may not be necessary that the Settlement Option Agreement be attached, as its provisions all can be incorporated in the Supplementary Contract itself. If the Interest Option is elected without any contingent beneficiary designation, the Settlement Option Agreement may be eliminated altogether, and a simple deposit receipt showing the amount of the proceeds, the rate of interest, when payable and the conditions pertaining to the withdrawals of principal should suffice. If the Interest Option with a single sum contingent beneficiary or another option with or without contingent beneficiaries named therein is requested, the Supplementary Contract should state the amount of the proceeds, the rate of income, the conditions determining payment and the contingent beneficiary, if any. In effect the Supplementary Contract should recite the provisions of the settlement option elected to the extent that they apply to the particular case. Any subsequent changes in the account or withdrawals of deposit proceeds should be endorsed upon this form.[49]

The simple Supplementary Contract form has many advantages over the more cumbersome policy endorsements. Its provisions are easily understood by the payee, as the method of settlement is stated simply, and the insurer's obligation is definitely limited. Furthermore, this form is more easily transferred for endorsement and subsequent changes or withdrawals.

The Supplementary Contract Payee. Although the Settlement Option Rider may not always so stipulate, it is

[48] This form together with the entire Settlement Option Agreement constitutes the supplementary contract.

[49] Note withdrawal provision in Appendix B.3.

intended that its provisions apply only to natural persons acting in their own right. The philosophy of income settlements is that they relieve the personal dependents of the insured of the burden of investing the insurance proceeds. It is felt that the settlement option privilege should not be available to corporations or institutions, as they should have ample outlets for investing surplus funds, although in the case of some charitable institutions or highly specialized corporations this reasoning may not be sound. It is further felt, perhaps unjustifiably, that the settlement option privilege should not be available to trust companies, as it is not proper that insurance companies assume the responsibility for investing trust funds, although, again, this reasoning is not applicable to trustees who are individuals, and insurance companies do assume the burden of investing pension trust funds. In the case of policies payable to executors or administrators it is felt that the settlement option privilege should not apply, as it is their primary duty to distribute the assets of the deceased and not to invest them and, if the insurance constitutes a large portion of the estate, the executor may delay unduly the closing of the estate in order to obtain the additional income.[50] The real objection to holding proceeds for impersonal payees is that if the Interest Option is elected, there is no contractual limit to the period during which the insurer is committed to pay interest if the payee does not withdraw the principal. In the case of an individual this period is limited at least to his lifetime. To meet this objection in the case of impersonal payees, it is recommended that the period of retention be definitely limited by contract to ten or possibly twenty years. A special option could be made available in such instances, or the language of the Interest Option could be revised.

It is apparent from the provisions of the contract that the settlement option privilege was not intended for such beneficiaries, as there is no basis upon which the income under the Life Income Option could be determined should they wish to elect this option. The courts have held,[51]

[50] See Appendix A.11.

[51] First Trust Co. of St. Paul v. Northwestern Mutual, 283 N.W. 236.

however, that in the absence of a more specific limitation in the contract,[52] a corporation may leave the proceeds on deposit with the company at interest. Thus insurance companies often are embarrassed under contracts which do not contain specific limitations as to the supplementary contract payee.

The situation is slightly different in the case of guardians or personal trustees. These individuals are merely acting for parties who are named in the contract and are intended as the beneficiaries thereunder but who are unable to be trusted to act for themselves through age, mental incompetency or emotional instability. Should an income beneficiary designated by the insured be incompetent or still a minor, the payment when due would have to be made to his legally appointed guardian, unless the insured had arranged for the payment of income otherwise.[53] By this reasoning the guardian should be allowed to elect an option following the insured's death, but the election should be accompanied by a court order authorizing the procedure. Such a court order usually is obtained easily. The right of a personal trustee to elect an option shall be governed by the terms of the Trust Agreement, and in the absence of any specific prohibitions it seems reasonable to permit an election.[54]

Frequently the payee may wish payment made to a third party instead. Such requests do not necessarily constitute assignments, as the payee may retain full control over the funds. Such requests arise usually if the payee travels considerably, resides abroad or has turned over the management of his affairs to a third party. By far the most frequent request of this sort is that payment be made to the payee's bank for deposit to his account. Little difficulty is encountered here if adequate authorization is submitted, except, as we shall see,[55] in the case of payments involving life contingencies.

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[52] See the final sentence of Clause 1, Appendix B.1.
[53] See discussion of settlement with minors, pages 68-70.
[54] See Appendix A.12.
[55] See discussion, page 111.

Requests for payment under a Power of Attorney are of little real concern to the insurer other than to determine the proper mailing address. The checks still should be drawn to the payee's order, but the attorney has full power to endorse them.

The Supplementary Contract Accounts. Upon maturity the accounting procedure is to debit the Death Loss, Endowment Maturity or Surrender [56] Accounts, as the case may be, and to credit the particular Supplementary Contract Account involved. Supplementary Contract proceeds may also partially result from debits to the Dividend or Double Indemnity Accounts. With regard to income policies matured by death, the same procedure is followed, although technically a Supplementary Contract may not be created at that time. This procedure is rarely followed in conjunction with the maturity of a deferred annuity, as these are covered through an adjustment in the policy reserve rather than through a journal entry.

The Supplementary Contract or Benefit Accounts to which maturity proceeds are credited are the Deposit, the Instalment and the Contingent Instalment Accounts. All funds to be retained under the Interest Option or to be paid under the Fixed Amount Option are credited to the Deposit Account. All funds to be paid under the Fixed Period Option or the Instalment Bond Option are credited to the Instalment Account, as are the proceeds of Family Income or other income policies which by their terms are payable in instalments certain. Credited to this account also is the present value of the certain instalments under the Life Income Option or under Continuous Instalment Policies, while the balance of the fund which is required to maintain the instalments after the certain period is credited to the Contingent Instalment Account. Whenever the proceeds are payable under the Life Income Option, a portion of the fund is credited to the Instalment Account and the remainder to the Contingent Instalment Account, un-

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[56] Usually called Lapse and Surrender (L. & S.).

less the option does not provide for certain instalments, in which case the entire fund is credited to the Contingent Instalment Account.

Income payments under Supplementary Contracts are debited to the Instalment, Contingent Instalment, Deposit, Contract Interest or Surplus Interest Accounts. One or more of these accounts may be debited with each payment.

The payment of instalments under the Fixed Period Option, the Instalment Bond Option and income policies not involving life contingencies and payments of instalments certain under the Life Income Option are debited to the Instalment Account. All such payments represent a partial withdrawal from the principal together with payment of all accrued interest to date. Because each successive payment reduces the amount of the principal, the interest accruing each time is less, so that with each payment a larger withdrawal of principal is necessary to maintain the instalments. The accounting of such payments would be extremely involved, were not some simple device created. This is achieved through the creation of the Instalment Account to which the entire payment is debited, instead of being divided between deposit and interest. The account is valued upon the reserve basis in much the same manner as annuity policies.

The entire amount of each periodical instalment under the Fixed Amount Option is debited to the Deposit Account, as each payment represents a deduction from the principal. Any additional withdrawals of principal under this Option or withdrawals of principal under the Interest Option are likewise debited to this account.

Interest payments are debited to the Contract and Surplus Interest Accounts. The guaranteed interest payments under the Interest Option are debited to the Contract Interest Account, and if these are augmented by payments of surplus interest, such payments are debited to the Surplus Interest Account. Under this option the interest instalments are reduced with each withdrawal from the principal. Under the Fixed Amount Option interest upon the balance of the principal is added periodically, a transaction that is completed through a simple journal entry debiting the Contract and Surplus Interest Accounts and crediting the Deposit Account.

Under the Fixed Period Option and the other options which involve the payment of instalments certain, the payment of contract interest is absorbed in the Instalment Account, but the surplus interest, if allowed, is payable in addition to the guaranteed instalments. Because the principal is reduced with the payment of each successive instalment, the surplus interest allowed must be smaller with each payment, even though a constant rate of surplus interest is maintained. It would relieve confusion both for the payee and the insurer were the Surplus Interest Account under such settlements adjusted to provide for the payment of equal surplus interest instalments as long as the same rate of surplus interest prevailed.

All payments under annuity policies are debited to the Annuity Account. This is done even in the case of payments certain under the Refund Annuity, as no distinction is made between contingent and certain payments. The account is valued upon the reserve basis, the reserve originating from the premiums paid. Annuity payments are very similar to payments under the Life Income Options, and a separation in the accounting is maintained only to fulfill annual statement requirements.[57]

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[57] Annuity payments are reported in Item III.6, and payments under the Life Income Options are reported in Items III.11 (a) and (b).

CHAPTER IV

THE PROVISIONS OF THE SETTLEMENT OPTION AGREEMENT

The provisions of the Settlement Option Agreement are the basis of the Supplementary Contract, so that the problems arising in connection with the preparation of this form warrant very special study. The purpose of the form is to cover all contingencies which might occur during the continuance of the Contract, to state the settlement option elected and to name all the beneficiaries or payees to receive thereunder. As a general rule these provisions, particularly when the election is made by the insured to take effect at his death, might be rather complex, even though the plan of settlement might be relatively simple.

The Contingencies. In the very earliest life insurance policies the beneficiary's interest was not subject to any contingency whatsoever. Apparently the possibility that the beneficiary might predecease the insured, in which case the insured might wish to cash in the policy or name another beneficiary, or even have the proceeds go to his own estate, had not been taken fully into consideration, and no provision covering this contingency was incorporated in the policy. In the absence of any limiting provision in the contract the courts held that the beneficiary was the absolute owner. To rectify this situation, the contract subsequently was written to provide that the proceeds would be paid to the beneficiary only if living at the insured's death, and if the beneficiary were not living they would be paid to the insured's estate, unless an alternate beneficiary had been named, so that the beneficiary's interest, whether vested or otherwise, was subject to a condition subsequent.[58]

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[58] See "Handbook of the Law of Insurance," by William R. Vance, Second Edition, pages 145, 146, 149 and 150, regarding the rights and interest of the beneficiary.

There are two possible contingencies that might be encountered here: the beneficiary might either survive or predecease the insured, in the latter of which instances the proceeds either pass to the insured's estate or to an alternate beneficiary.

The situation becomes much more complicated if the proceeds are to be paid to the beneficiary as income. The beneficiary might either predecease the insured or might die before receiving all the income. The problem of what to do with the income remaining unpaid at the beneficiary's death was one that baffled the earliest pioneers in income settlements. It was not clear whether the unpaid proceeds were to be considered as the property of the beneficiary or of the insured. To pay the remainder to the insured's estate might require reopening the estate many years after his death, a questionable legal procedure, so that the most logical solution appeared to be to provide for payment to the estate of the beneficiary.

As a matter of fact, the assumption is that the beneficiary will live to receive all of the proceeds, as otherwise there is little purpose in electing the option. But the possibility of the beneficiary's premature death should not be ignored. In some cases payment to the beneficiary's estate might defeat the original purpose of the policyholder. The heirs of the primary beneficiary might not be the persons whom the insured wished to benefit, should the primary beneficiary die prematurely. In such instances the situation could be rectified by naming an alternate or contingent beneficiary to receive those proceeds payable either at the primary beneficiary's death while receiving income or at the insured's death should the primary beneficiary predecease the insured.

Furthermore, the same factors which render an income settlement desirable for the primary beneficiary might apply in the case of the contingent beneficiary, and in some cases the income settlement might be intended more for the contingent beneficiary's benefit. This latter situation would prevail where the income for the wife was intended to provide for rearing the children, in which case the purpose would be defeated by a single sum payment to the children before they were self-supporting.

To rectify this situation life insurance companies will permit the income to continue to a second or contingent beneficiary. In some instances, such as where the income is to provide for the family, this procedure is entirely justifiable, but the inclusion of each successive income beneficiary tends to complicate the contingencies considerably.

As we have seen, there are but two contingencies to be covered when the beneficiary is to receive the proceeds in a single sum; the beneficiary might either predecease or survive the insured. This number is increased to three when income is to be paid only to the primary beneficiary, as the beneficiary might survive the insured but die before receiving all the income. When, however, income is to be paid to the primary beneficiary, if living, otherwise to the contingent beneficiary, the number of contingencies to be covered is increased to seven. If, for example, the proceeds are to be paid in instalments for ten years under the Fixed Period Option to the primary beneficiary, if living, otherwise to the contingent beneficiary, there are seven different ways in which the proceeds might be paid depending upon when the insured, the primary beneficiary and the contingent beneficiary die: the primary beneficiary might survive the insured and live to receive all the instalments; the primary beneficiary might survive the insured but die within ten years of his death, the entire balance of the instalments going to the contingent beneficiary; the primary beneficiary and contingent beneficiary both might survive the insured by less than ten years, and the contingent beneficiary might survive the primary beneficiary, so that the estate of the contingent beneficiary would receive in a single sum as final payee; the primary beneficiary and contingent beneficiary both might survive the insured by less than ten years, but the primary beneficiary might survive the contingent beneficiary, so that the estate of the primary beneficiary would receive in a single sum as final payee; the primary beneficiary might predecease the insured and the contingent beneficiary survive the insured and receive all the instalments; the primary beneficiary might predecease the insured, and the contingent beneficiary might survive the insured by less than ten years, her estate receiving in a single sum as final payee; both primary beneficiary and contingent beneficiary might predecease the insured, so that the insured's estate would receive the entire proceeds in a single sum at his death.

This situation applies with reference to a very simple settlement involving only two beneficiaries. An increase in the number of beneficiaries named would add still more to the number of contingencies, even though the actual plan of settlement might not be greatly altered. For example, the inclusion of a second contingent beneficiary to receive in a single sum at the death of the survivor of the insured, the primary beneficiary and the contingent beneficiary increases the number of contingencies to eleven. The naming of two individuals or the survivor to receive the income, as primary beneficiary or contingent beneficiary increases the number of contingencies by four more in each case. If the number of simultaneous income payees is increased to but three, the number of contingencies are more than quadrupled.

It is essential that the provisions of the Settlement Option Agreement cover all of these contingencies, and for this reason the provisions of the Settlement Option Agreement might be extremely lengthy in some cases. Although frequently several of the contingencies can be grouped together and covered in a single phrase, it requires years of experience in draftsmanship to be able to do this effectively. The language employed to cover the usual request has been standardized so as to cover all contingencies briefly but completely.[59] The inclusion of an irregular provision might complicate the contingencies more than is at first realized.[60] It has been held that the more involved cases should be drafted by an attorney, although this view

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[59] Note how all the contingencies are covered in Article II of Appendix B.2.

[60] See Appendix A.13.

is not generally maintained, as the problem is more apt to be literary or mathematical than legal. The actual drafting of the agreement in our opinion need be entrusted to an attorney only when the use of legal language therein is required for which there is no precedent.

Generally, provision for payment to two successive income beneficiaries with a final single sum payee is an acceptable arrangement. The payment of income to three successive income payees increases the number of contingencies considerably and generally is undesirable for reasons which will be cited later. When income is to be paid to several payees simultaneously, such an arrangement, although it may increase the number of contingencies considerably, does not increase the difficulty of draftsmanship if each payment is shared equally by the surviving payees. Complications arise only when an irregular division is desired or when the income payable to each individual in the class is to be disposed of differently upon his or her death. If the request is unusually complicated in these respects, the company is justified in refusing to include all the provisions requested.

The Settlement Option. In addition to covering all the contingencies the Settlement Option Agreement must state the settlement option under which the income shall be paid. Full details pertaining to the plan of payment should be given, as it is not sufficient merely to identify the option by name or number. The practice usually is followed by stating the option elected; the period during which the instalments certain shall be paid under the Fixed Period, Life Income or Instalment Bond Options, or the amount of income under the Fixed Amount Option; the frequency of payment, whether annually, semi-annually, quarterly or monthly; and the payee's right to withdraw or commute principal, whether permitted freely, limited or prohibited altogether. The payee may be given a restricted privilege of selection as to the period or the amount of the income, and it is not absolutely necessary that the frequency of payment be specified, the choice in this respect being left with the payee. The policyholder's intention with regard to the withdrawal privilege should be set forth clearly, unless the option elected, by its terms, specifically prohibits withdrawals, as otherwise the rights of the payee in this regard would be in doubt. In the absence of definite direction from the policyholder in this respect, the usual practice is to provide withdrawals under the Interest Option but to prohibit them under any of the other options, such provision being inserted in order that the Agreement may not be absolutely silent on this point.

Though usually not specifically permitted by the Settlement Option Rider, the practice of using more than one option in the settlement under one policy often is permitted. If two or more options are effective simultaneously, each being applied to a separate portion of the proceeds, the Agreement is in effect a combination of two or more independent settlements. As a matter of fact, the entire proceeds frequently are not held under a settlement option, a portion being paid in a single sum for cleanup purposes.[61] When two beneficiaries are designated, each to receive a portion of the proceeds under different options, the same result could be achieved by reissuing the policy in two independent policies and writing a different Settlement Option Agreement under each. We believe, however, that it is preferable to write separate simultaneous agreements, embodying in each the respective plans of settlement, as the reissuance of the policy in two parts accomplishes nothing but to increase the general administration cost to the company.[62]

The drafting of the agreement is apt to become involved when the proceeds are held under one option to be followed at a later date by payment under another option. We have pointed out how a desirable arrangement may be achieved through holding the proceeds under the Interest Option until some future date when they may be applied to procure an income under one of the other options. A similar effect can be produced through the use of the Fixed Amount

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[61] See Article III E of Appendix B.2.
[62] See Appendix A.14.

Option, and the single sum payment under the Instalment Bond Option could be used effectively if paid under another option. It is only the Fixed Period and Life Income Options that do not lend themselves intelligently to subsequent settlement under another plan.

Such a combination of options increases the contingencies to be covered, as each income payee might die while receiving under either option. If the plan of settlement remains the same regardless of the payee, the required draftsmanship is simple, but when the plan of settlement varies depending upon whether the primary beneficiary or contingent beneficiary is receiving income it might be necessary that the agreement be extremely long and intricate. For example, if a fund is retained on deposit for a child to be paid as an education income when he becomes eighteen years old, and if as contingent beneficiary another child is named to receive income under the same plan, except that the income will not start until the second child becomes eighteen years old, a complicated situation results. The primary beneficiary might die before age eighteen, but after the contingent beneficiary already is eighteen, or the primary beneficiary might die while receiving income after age eighteen but before the contingent beneficiary is eighteen. In either case an identical settlement for the contingent beneficiary is impossible, and in some instances the settlement might change from the interest to an income option, then back to the Interest Option and then, finally, change to an income option again when the contingent beneficiary becomes eighteen years of age unless otherwise provided in the agreement.

A combination of options also may compel the company to retain the proceeds for a longer period than is desirable in view of the fact that a stipulated rate of interest must be guaranteed throughout this prolonged period. The maximum period of retention is definitely limited under the Fixed Period and Instalment Bond Options. Under the Life Income Option it is limited to the certain period or the lifetime of the primary beneficiary. Under the Fixed Amount Option the maximum period of retention is limited only if there is a limitation on the minimum annual income. By holding the proceeds under the Interest Option to be paid under one of these other options at a later date, the period of retention is extended.

The question of prolonged retention of the proceeds is of most significance under the Interest Option. Many companies endeavor to restrict the period of retention under the Interest Option to a definite number of years, usually thirty, but such restriction is unenforceable unless stipulated in the provisions of the settlement option itself. If the option permits retention during the lifetime of the payee, the policyholder may demand that the proceeds be retained for this period. It follows, then, that there is little purpose in restricting the maximum period of retention during the lifetime of the primary beneficiary regardless of what plan of settlement or combination of options is requested. During the lifetime of the contingent beneficiary the company is not prohibited by policy provisions from limiting the period of retention if the Settlement Option Rider includes no provision for payment to a contingent beneficiary and many companies will not permit retention for the contingent beneficiary beyond a period such as thirty years after the insured's death.

The Beneficiary Designation. Another function of the Settlement Option Agreement is to name the beneficiaries. This function may not be necessary if there is to be no change in the beneficiaries previously designated, but in practice it is usually preferable to incorporate in one instrument all the items relating to the settlement in order that it may be complete. If one settlement is governed by two independent agreements, ambiguity regarding some issues might result.

It follows, then, that the Settlement Option Agreement is a Change of Beneficiary form. To fully clarify the issue, the insured, in completing the form, should revoke all previous beneficiary designations and settlement option elections. For purposes of identification the Settlement Option Agreement should set forth the beneficiary's name and relationship to the insured. The beneficiary's date of birth also should be shown if she is to receive under an option whereby the income is determined by her age, if changes in the settlement are to take effect when she has attained a certain age or if the beneficiary is a minor. When a person who is not a relative of the insured is to be named as a beneficiary, it is advisable for all parties, the insured, the agent and the company, to proceed with caution, as such action is inviting a counterclaim from any relative of the insured who may be deprived of any benefit thereby.

Beneficiaries fall into several classes commonly designated as *primary*, *contingent*, *second contingent* and *final*. The primary beneficiary takes immediately at the insured's death; the contingent beneficiary takes only if the primary beneficiary is not living, and the second contingent takes if both the primary and contingent beneficiaries are not living. The final beneficiary takes whatever is left when the settlement is terminated.[63] The naming of numerous alternate second contingent beneficiaries as final single sum payees involves no problem except that under complicated income settlements there are several different contingencies under which they might receive, so that in drafting the agreement it might be desirable to avoid repetition of this lengthy list of names if possible.

One individual may be designated as beneficiary in each class, or in one or more classes several individuals may be designated. For example, the contingent beneficiary might be all the insured's children of which there are four. The designation in this way of numerous concurrent beneficiaries in the same class involves no problem if the beneficiaries receive share and share alike, the survivors or survivor, except that such an arrangement has little purpose if the income is so small that each payee's share will be negligible. If the income is not to be divided equally between the payees, the mathematics of disposing of the share of any deceased payee is involved, particularly if there are more than two such beneficiaries. If the share

[63] Note how these are indicated in Appendix B.7.

of any deceased payee, instead of reverting to the survivors, is to be paid to some third party or parties, such as the payee's children, the agreement becomes much more complicated, particularly under the options which are payable from the Instalment Account where no definite portion of the proceeds need be allocated to each payee. Irregularities in the treatment of a class of payees greatly complicates the problem of drafting the agreement.[64]

Another problem in naming several beneficiaries is encountered when several successive income beneficiaries are requested. We have already seen how the number of contingencies increases with an increase in the number of income payees.[65] A large number of such payees also has a tendency to increase the period of retention, particularly under options which by their nature do not limit this period. Under the Interest Option the fund could be retained for several generations by naming children, grandchildren and great-grandchildren as successive income payees if they could not or chose not to withdraw the proceeds. Such a settlement might be construed as a violation of the law against perpetuities,[66] and certainly it would impose a prolonged investment obligation upon the insurer. Aside from the possible legal objection, there is no great objection to naming three or more successive income payees under an option such as the Fixed Period Option, where the period during which payments will continue is definitely limited, although there is little practical justification for such an arrangement, and the drafting of the agreement might be complicated through the introduction of additional contingencies. The practice usually followed is to restrict the number of successive income beneficiaries to two, although each may be several individuals treated as a class.

For reasons previously cited[67] it is undesirable that corporate or impersonal beneficiaries receive income under

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[64] See Article IV C and E of Appendix B.2.
[65] See pages 52-53.
[66] See Appendix A.15.
[67] See discussion on pages 8 and 45.

a settlement option, although such may be designated as single sum payees. The only exception to this principle is found in the case of representatives for minors or mental incompetents. We shall discuss in the next chapter the various methods by which settlement with minors may be effected.

Unnamed Beneficiaries. The practice of requiring that the beneficiary be designated by name is generally followed, and life insurance companies prefer not to allow provision for payment to individuals who are not named, but who are identified through some other means, such as their relationship to the insured. The reason for this is that when a class of unnamed individuals is designated, the number of beneficiaries and the identity of each is in doubt. There is little question as to the proper recipient of the proceeds if the beneficiary is named and is further identified through his or her relationship to the insured. On the other hand, if the beneficiaries are not named, but are designated in some other way, the burden falls upon the company of determining both the number of beneficiaries and the identity of each, and the company is confronted with the possibility of an adverse claim from a duly qualified beneficiary who may have been overlooked.

An exception to this practice is to be found in the case where the policyholder wishes to designate all his children as beneficiaries, including those to be born in the future. To refuse this request and to confine the designation to the living children would result in unfair discrimination against those children who were so unfortunate as not to be born at the time the designation was made and, as a consequence, would be contrary to public policy. Even were the policyholder to change the beneficiary promptly upon the birth of each child, a posthumous child still would be deprived of any benefit from the insurance.

The inclusion of unnamed children as beneficiaries would not result in many of the hazards resulting from unnamed beneficiaries generally, since, except in very unusual cases, it should not be a difficult problem to locate and identify all of the children at their parent's death. The danger of an adverse claim, such as, for example, might be presented by an illegitimate child, is reduced to a minimum through employing such phraseology as "the children born of the marriage of the insured and his wife named herein." The use of the term *lawful children* is not recommended by some authorities who construe this phraseology as placing upon the insurer the burden of guaranteeing the validity of the alleged marriage of the insured.

The situation becomes much more complex when the insured wishes to include in the beneficiary designation provision for payment to his children *per stirpes*; that is provision by which the issue of any child who is not living shall share equally the sum which their parent otherwise would have received. It is only natural for the insured to wish the share of any deceased child to pass to its children rather than to its surviving brothers and sisters. In many instances where this provision is desired, however, the children may not even be of marriageable age, so that the phraseology generally employed in designating the policyholder's unborn children will not apply. If any of the children are married, the designation can be limited to include only the children born of the marriage of the child and his or her spouse, but when the children are unmarried, it is necessary to use some such phrase as *"children of the children of the insured."* The use of the term *issue* or *per stirpes* should be avoided unless carefully defined, as this term places no limitation upon the number of generations to receive the proceeds.[68]

The practice of including the unborn children of the insured's children in the beneficiary designation is one that might create a serious problem for the insurance company. Question arises depending upon the jurisdiction involved whether illegitimate children and adopted children are included or excluded. The company is confronted with the burden of locating all of the children at the time of settlement, and in some instances must assume the risk that all of the rightful claimants have not been located.

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[68] See Article IV D and E of Appendix B.2.

The problem of unborn children is frequently encountered under income settlements. The insured's children often are named as contingent beneficiaries to receive income, and when such is the situation it is not unreasonable to expect any balance due at their respective deaths to pass to their respective children. When this is done, the contingent beneficiaries do not receive as a class share and share alike, the survivors or survivor. Under the instalment options it involves the partial commutation of future instalments.[69]

Except in the case of the unborn children and grandchildren of the policyholder, the practice of designating beneficiaries who cannot be identified by name is generally discouraged. The company may decline to name the unborn children of some third party, as in most instances there is little justification for their inclusion. The designation of the unnamed spouses of the insured's children who are unmarried should not be permitted by the company because such a designation places it in the position of being compelled to guarantee the marriage of the children in question, and the situation may become complicated through secret marriages or contested divorces.[70] The designation of unnamed individuals who are identified through their membership in some specific group is discouraged because of the possible ambiguities which may arise.

The Final Payee. Unlike a will, a Settlement Option Agreement always provides for final disposition of the proceeds should all of the beneficiaries die before the policy proceeds and interest thereon have been paid in full. Should all of the legatees under a will predecease the maker, the estate would go to his heirs or nearest of kin. It would be unreasonable to expect the insurance company to assume the responsibility of administering an estate in this way, of determining who the proper heirs are and of

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[69] Note how this is provided in Article IV e of Appendix B.2.

[70] See Horton "Making the Best Use of Your Insurance," pages 49-50.

locating and identifying them to make payment. Because of this difficulty and because of the litigation often resulting, provisions for payment to the heirs or to the nearest of kin are not included in Settlement Option Agreements, but a definite provision for final distribution when all of the income payees have died is included instead.

The final beneficiary usually is the executors or administrators of the survivor of the insured, the primary beneficiary and the contingent beneficiary. This arrangement is extremely logical, as the unpaid proceeds are in reality the property of the surviving payee and through his estate are payable to his heirs. This arrangement is not always the most satisfactory to the policyholder, however, as the heirs of the surviving income payee may not be his heirs or those individuals whom he would wish to receive any residue. In cases where this situation prevails, the policyholder can offset it considerably by providing for payment in a single sum to certain designated remote relations or other persons as final payees. This will minimize the possibility of the proceeds going to the heirs of the surviving income payee, although the estate of the survivor of the insured and the income beneficiaries, nevertheless, should be named as final contingent beneficiary. The naming of individuals may prove difficult, should this involve nieces and nephews not in being at the time of the election.

Occasionally a religious, charitable or educational institution may be the final payee. When this is done, the danger that the final beneficiary at the time payment becomes due will be of obscure identity or not in existence through merger or dissolution is much greater than in a case not involving a deferred settlement, owing to the additional passage of time.

Another plan by which payment to an estate might be avoided is to provide for final payment to a trustee. In such cases a trust should be created which should be in existence at the time the payment in question becomes due.

To avoid the possibility of final payment going to the heirs of the surviving income payee, the insured may wish to insert in the Settlement Option Agreement a special provision by which payment to his heirs may be effected in this contingency through naming his own estate as final payee instead of that of the surviving income beneficiary. The disadvantage of this plan is that the insured's estate would have to be held open during the entire time the insurance proceeds are being administered, while the period during which an estate may be held open usually is definitely limited.

If the estate has been closed before the death of the last income payee, it is questionable whether the estate could be reopened. Many states have laws which definitely limit the time and purpose for which an estate may be reopened. It is maintained by some authorities that an estate can never be reopened to receive the unpaid insurance proceeds upon the death of the survivor of all income beneficiaries because the only property that an estate can claim is the property owned by the deceased at his death, and the insurance proceeds did not belong to the insured at any previous time. Because of these complications it may be extremely difficult to effect final payment in many cases without excessive legal expenses. It should be borne in mind that such expense will fall upon the estate, so that there may be very little left to distribute. The insured may leave his heirs a law suit rather than a legacy. If, however, such a distribution is preferable from the insured's point of view to the normal distribution, the insurance company will probably feel obligated to draw the agreement as requested, but in so doing it should take especial pains to bring to the insured's attention the possible pitfalls.[71]

A similar situation arises should the final payee be the estate of some third party other than the insured or final income payee. This situation is encountered primarily in cases where the insured wishes to divest himself of all ownership of the insurance as a tax avoidance measure, as the proceeds would not be held as tax exempt if under any possible circumstances the proceeds might revert to the

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[71] See Horton "Making the Best Use of Your Insurance," pages 49-50.

insured's estate. The problem here, however, is not so serious, as probably the election would be in connection with an assignment or other transfer of ownership, so that ownership should pass immediately upon the prior death of the assignee.[72]

The Spendthrift Provision. Many states have statutes by which life insurance proceeds when payable in instalments are exempt from the creditors of the beneficiary, provided the insured has so specified. Because of the fact that this provision is requested in almost all cases, it is automatically incorporated in the Agreement as one of the printed provisions,[73] and some companies even go so far as to incorporate it in the Settlement Option Rider.[74] This provision is commonly called the *Spendthrift Clause*, the legal expression being *restraint on alienation.* It provides that insofar as is permitted by law no benefits accruing to any beneficiary shall be transferable or subject to commutation or the claims of creditors. It should be noted that this provision will be effective only when the terms of the agreement and the laws of the prevailing jurisdiction render such provisions enforceable.

In any case this provision clearly could not apply to an election made by the payee after maturity as an endowment or after surrender for cash, to an election by the beneficiary after the insured's death, nor to an election by the absolute assignee for his own eventual benefit. Its effect is questionable if the beneficiary, by the terms of the agreement, is given the right of withdrawal or commutation, as conceivably a creditor might compel the beneficiary to exercise this right.

The legal concept of this clause is obscure. The American view is that not only is the beneficiary unable to anticipate future payments through commutation or pledge as collateral, but the beneficiary cannot waive or refuse

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[72] See discussion of transfer of ownership on pages 85-89.
[73] See Article III A of Appendix B.2.
[74] Instead of having a general printed clause, still other companies have available a selection of clauses to be used depending upon the state in which the policyholder resides.

payments as they become due. The English view is that an attempted violation of this provision automatically deprives the beneficiary of any further rights, and the insurer may pay the proceeds at its option to the next of kin.[75]

Other Miscellaneous Provisions. Incorporated in the Settlement Option Agreement are many provisions and clauses: these cover the naming of the beneficiaries to receive payment, the statement of the settlement option elected, the provision for distribution of any unpaid accounts should any of the beneficiaries die prematurely, the revocation of any previous agreement or beneficiary designation, the Spendthrift Provision and, finally, numerous provisions of lesser importance to clarify the obscurer points not covered elsewhere. These lesser provisions cover principally the definition of terms and the clarification of administration procedure.[76]

The agreement should define clearly the policy proceeds referred to. The status of dividend deposits [77] and double indemnity proceeds, particularly, should be clarified.[78] As regards the latter, it should be noted here that if the double indemnity payment is to be treated as a part of the proceeds, its effect under the Fixed Amount Option will be to increase the period during which the income will be paid and not the amount of the income.

The procedure upon the death of a beneficiary should be set forth so as to relieve the company from any detriment it may suffer through lack of knowledge of the occurrence of any contingencies affecting payment. Additional protection in this respect would be afforded through a clause to the effect that the company may rely solely upon affidavit or other satisfactory evidence of any pertinent facts and is relieved of any further liability or responsibility through acting in reliance thereon. As further protection a clause should be inserted placing the

[75] See Appendix A.16.
[76] See Article IV of Appendix B.2.
[77] See Appendix A.17.
[78] See Article IV G of Appendix B.2.

responsibility upon the payee to notify the insurer of any occurrence or change in the status of the settlement, so that the burden for proper administration of the funds in these respects is upon the payee and not upon the insurer.[79]

It is also advisable to include any reasonable limitations upon the income or withdrawal privilege that may not be specifically covered by the Settlement Option Rider to relieve the insurance company of any unjustified expense in administering small accounts. To eliminate any possible misunderstanding, it is wise to indicate that any interest or instalment accruing between the most recent payment and the death of the payee shall be paid to the next succeeding payee.[80]

While the agreement we are discussing is an election by the insured for disposition at his death, there is always the possibility that the policy may mature as an endowment in which case he may wish the benefits himself. A brief provision covering the endowment maturity proceeds is in order.[81]

Though not obligatory, it may clarify the issue if a provision to the effect that any income payable to a minor shall be paid through the guardian is inserted. For the same reason it is wise to show that the terms of the agreement are subject to any prior or subsequent assignment.[82] Finally the insurance company may be protected if the insured certifies that he is not involved in bankruptcy.[83]

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[79] See Article IV I of Appendix B.2.
[80] See Article IV J and L of Appendix B.2.
[81] See Article IV P of Appendix B.2.
[82] See Article IV B of Appendix B.2.
[83] See Article IV F of Appendix B.2.

CHAPTER V

SETTLEMENT OPTION AGREEMENT PROBLEMS

The Settlement Option Agreement becomes quite intricate and complicated when numerous beneficiaries are designated or more than one settlement option elected. Not only is the actual material incorporated in the agreement increased, but the agreement is further complicated through the resulting increase in the contingencies that must be covered.

In the preceding chapter we have endeavored to cover the general provisions of the agreement, the technique required in its preparation, and the immediate resulting problems. In this chapter we shall endeavor to cover some of the special problems occasionally encountered and shall conclude with a summary of the important factors to be considered by the agent, policyholder and insurance company. Some of the special problems to be considered are payment to minors, modification of the provisions of the settlement option, special privileges given the beneficiary and the inclusion of provisions involving unusual contingencies.

Special Provision for Settlement with Minors. When the income is for a minor, as in the case under education settlements, payment must be made to the beneficiary's guardian until the beneficiary comes of age. This practice involves court procedure and the expense incidental thereto to appoint a guardian, and the guardian, once appointed, obtains his authority from the court and might be so limited thereby in the extent to which he may apply the income thus payable as to defeat the original purpose of the settlement.

Three plans have been proposed to offset the disadvantages of payment to the guardian during the minority of the beneficiary: the income may be paid to a third party, to a trustee or directly to the beneficiary. All of these plans have their advantages and disadvantages, so that the determination of which one is preferable depends upon the circumstances of each individual situation.

The plan by which payment is made to a third party eliminates all legal difficulties and expense. The third party, usually a parent of the children, may use the proceeds as he or she sees fit without having to submit to any superior authority. It should be remembered, however, that this third party is under no legal obligation to use the income for the benefit of the child. Also, if the third party is not the contingent beneficiary, an awkward situation might arise should the primary beneficiary die and the company not be informed. Finally, it might be held that the third party is personally liable for income tax on the income thus received and this income would fall in the higher brackets if this party already enjoyed substantial income.

The objection that the recipient of the income is under no legal obligation to use it for the beneficiary may be overcome through the second plan suggested by which payment is made to a trustee. If, in this connection a corporate trustee is so designated, it probably would be preferable to arrange settlement under an independent trust. A personal trustee, however, may be designated to receive the income during the beneficiary's minority, but the company should require evidence that a Trust Agreement is entered into with the trustee. If there is no Trust Agreement, the arrangement is without purpose, as the trustee so designated has no power and must turn the payments over to the beneficiary's guardian.[84] The powers of the trustee may be restricted or liberalized, so that the policyholder has a reasonable assurance that the income will be used properly.

Question has arisen as to whether it is not proper to pay to the parents or natural guardian as trustee without requiring that there be a Trust Agreement, although many authorities do not recommend this practice.[85] Payment to

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[84] See Appendix A.18.

[85] While the parent is the natural guardian of the person of a minor, a minor's estate can be disposed of only by proper order of court.

the trustee may be made only during minority, and this plan is very similar to the previously mentioned plan of paying directly to a parent. The payee is not restricted in the application of the money so paid, although through the designation of the payee as trustee the beneficiary might question any gross misappropriation. Some authorities believe that if the Settlement Option Agreement is so drawn as to provide for payment to the trustee "for the benefit of" the minor, it assumes the properties of a trust agreement.

The difficulties arising through payment to a third party for the benefit of a minor may be overcome by providing for making payment to the minor directly. A few companies, when requested by the policyholder, will include in the agreement a provision to the effect that payment will be made to a minor after age sixteen without the intervention of a guardian. This may be included upon the theory that the payments to the minor are in the nature of a gift, so that there can be no basis for subsequent action against the company which is acting in strict accordance with its contract with the insured. A large number of insurance companies will not include such a provision in their agreements because of the questionable legal issues involved in such a settlement. If used, it should be limited in its scope to small payments, nor is it wise to permit a minor to exercise discretionary powers such as the withdrawal privilege.

Modification of the Provisions of the Settlement Option. Notwithstanding the number of settlements that can be effected through the use of settlement options and income policies, there occasionally is encountered a situation where no settlement option or combination of settlement options, in spite of their flexibility, will achieve the desired result. Requests for minor variations in the terms of the settlement options, such as the request for payment for a certain period not specified under the Life Income Option, should be refused unless they are sufficiently numerous to warrant revising the option. Such requests do not constitute the most frequent problem in this connection; the real difficulty arises in conjunction with requests that periodical instalments be accumulated or that their period or amount be varied.

One of the uses of the Interest Option is to conserve the proceeds for payment under another settlement option at a later date when the income will be more needed. In such instances it might be preferable to allow the interest to accumulate to be applied toward procuring additional income under the subsequent option, an arrangement that might prove of more benefit than the small immediate interest income that would be payable. Under such an arrangement the deposit becomes similar to a savings account.

The policy contains no option providing for the accumulation of interest, so that the company is not obligated to do so, although there is no legal difficulty in allowing this, provided the laws against perpetuities are not violated. A few states have specific statutes restricting the period of accumulations.[86] Insurance companies prefer to discourage accumulation of interest because of the additional expense incurred in handling the account and because of the additional liability created, as interest must be calculated and credited periodically.

As a general practice it is perhaps best to permit accumulation only for the benefit of minors during the period of their minority. Accumulation of instalments payable under any option other than the Interest Option is not feasible. The practice of permitting accumulation for minors may be justified upon the theory that the company could be compelled to retain the proceeds, if the family of the beneficiary refuse to have a guardian appointed. By accumulating proceeds during minority the problem of payment to minors is eliminated, and the fund for education or for use after coming of age can be increased.

Often settlement options are used to provide an annual gift for the beneficiary, the policyholder wishing the instal-

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[86] Among the states having laws which prohibit perpetuities and require that all estates must vest immediately are Alabama, California, Idaho, Illinois, Indiana, Montana, New York, North Dakota, Pennsylvania and South Dakota.

ments to be paid annually at Christmas time or on the beneficiary's birthday. Under the provisions of the settlement options in the policy the payment of instalments shall commence immediately upon the date of maturity. To provide for payment at the desired time, the request is frequently made that provision be included in the agreement to the effect that payment shall be on some stipulated date. There is no real objection to including such provision if there is no further complication. This could be achieved through retention under the Interest Option with or without interest until the desired date, at which time payment of interest or instalments could commence.

The situation would become more complicated if payment on two specified dates not involving semi-annual payments were requested, since such a request would involve periodical payments which were not in accordance with the provisions of the policy. It would be necessary that the proceeds be divided into two parts and that each part be paid in annual instalments on one of the dates specified. If, however, payment is requested on several different specified dates throughout the year, the division of the proceeds into many parts might prove too cumbersome.

To take care of seasonal fluctuations it is sometimes desirable that the income be paid in monthly instalments of amounts varying throughout the year. This situation arises particularly in connection with education settlements, in order to provide a substantial payment in September and February to cover tuition expenses and a moderate income throughout the rest of the year, except during the summer months, to cover current expenses.

To meet the growing demand for such special settlements many companies will arrange such a plan notwithstanding its many undesirable features. This plan of payment can be applied as a modification of the Fixed Amount Option where the payments could be treated as withdrawals from the principal account. This mode of settlement places an additional burden upon the company, since the routine in the administration of Supplementary Contracts is designed upon the assumption that the payments will be periodical and of even amounts. Monthly payments eliminating the summer months must be treated as a separate group, and additional accounts must be created providing for annual payments in September and February.

Special Privileges Given the Beneficiary. Although the purpose of the Settlement Option Agreement is to restrict the rights of the beneficiary to the receipt of the income under the option elected, the policyholder may wish to give the beneficiary some limited privileges of a discretionary nature. These usually involve the right to withdraw or commute the proceeds, the right to modify the election or the right to designate a contingent beneficiary to receive any proceeds remaining unpaid at the payee's death. The latter of these privileges is rarely allowed, as it is of little real benefit to anyone. It might be construed as conferring upon the primary beneficiary full ownership of the proceeds, and the only method by which she could confer property at her death would be through the regular testamentary procedure.

The right of withdrawal often is permitted by the terms of the settlement option. It is always provided for by the terms of the Interest Option and usually by the terms of the Fixed Amount Option. It may be specifically prohibited under the Fixed Period or Life Income Options. When, as often is the case, the terms of an option are absolutely silent upon this question, the allowing of withdrawals depends entirely upon the practice followed by the company. It frequently is prohibited under options payable from the Instalment Account.

Although the right of withdrawal may be permitted under the Interest or Fixed Amount Options, the policyholder usually may modify this privilege when electing one of these options for the beneficiary. The right may be limited to a stipulated amount annually; it may be deferred so as to be effective only after a stated date; it may be restricted to only a portion of the proceeds; or it may be withheld altogether. Under the Fixed Period or Life Income Options such flexibility is not practical, and it is best to permit commutation only if the entire commuted value be taken and the account terminated.[87]

Another privilege which may be given the beneficiary is the right to modify the plan of settlement to conform better with her needs. The Interest Option may be elected by the insured with the intention that the beneficiary may choose a plan of settlement better suited to her needs when the insured's estate has been settled and the beneficiary can estimate more accurately the amount of income required for living expenses.

This privilege operates best when the Interest Option has been elected originally, but it may be applied under some of the other settlement options also. Under the Fixed Amount Option the policyholder may intend that after the beneficiary has received income for a specified period she be given the right to modify the plan of settlement to provide either a life income or an income more suited to current needs. Also, under the Instalment Bond Option the policyholder may wish the beneficiary to have the right to receive the single sum under an option. Under the Fixed Period Option a modification of the plan of payment is cumbersome unless the option is rescinded in favor of another one at its inception. A subsequent change while receiving under the Life Income Option to another option should not be allowed because the payments under this option involve life contingencies.

The extent of the privileges conferred may vary: the beneficiary may be given the right to change to any other option; the beneficiary may be given the right to change to any other option but with the understanding that the income thereunder may not exceed a specified amount; or the right of the beneficiary to elect another option may be limited to one particular option designated by the insured.

The advantages of an unrestricted privilege to change are extremely dubious, since the effect of such an election is similar to designating a single sum beneficiary. In either case the beneficiary may elect any option in the policy or may receive the proceeds in a single sum. The possible

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[87] See discussion on page 9.

advantages to be derived from such an election are to bring home to the beneficiary the settlement option privilege, to permit the policyholder to designate contingent beneficiaries to receive at the primary beneficiary's death and to give the beneficiary the right not guaranteed in the policy to make the election after considerable time has expired following the insured's death.

The first of these aims is probably the best justification for this arrangement. The second, though allowed by many companies, is not wholly justified, as the practice of permitting the beneficiary to elect any option at any time and yet provide for distribution among contingent beneficiaries at her death not only complicates the agreement through the multiplication of the contingencies to be covered but is questionable in that under such circumstances the proceeds are in effect the property of the beneficiary. When such broad powers are given the beneficiary, she should also be given the right to designate a contingent beneficiary upon the same condition as would apply when the beneficiary makes an election after the insured's death.[88] As to the third aim, the privilege, by company practice, usually is restricted to a short period following the insured's death.

The purpose of such an election would have more point if the right of withdrawal were limited or withheld and if the election by the beneficiary were restricted as to the annual income. The purpose then would be to restrict the beneficiary's rights yet allow a considerable degree of flexibility.

When, instead of giving the beneficiary the right to elect any option, this right is restricted to but one option that is selected by the insured, the situation is simplified. Legal authorities view this arrangement more favorably, as it is viewed not as giving the beneficiary the right to make an election but rather as giving the beneficiary the right to select between two options previously elected by the insured. The insured may designate contingent beneficiaries and direct how they shall be paid should the primary

[88] See Article III C of Appendix B.2.

beneficiary die while receiving income under either option. The inclusion of this privilege increases the number of contingencies which must be covered in the agreement.

When the privilege of selection is limited to but one other option, it is not always necessary that a time limit be imposed as to when the alternate plan of settlement may be chosen, provided the option to be elected does not involve life contingencies. If, for instance, the Interest Option is elected for the beneficiary with the right to select instead the Fixed Period Option for fifteen years, there is no practical objection to permitting the beneficiary to receive full interest for ten years and then elect to receive instalments under the Fixed Period Option for fifteen years thereafter.

More frequently this problem involves the Life Income Option. It is not uncommon for the policyholder to elect the Interest Option for the beneficiary, giving the beneficiary the right to change to the Life Income Option. This arrangement is requested instead of immediately electing the Life Income Option because it involves life contingencies. Should the primary beneficiary be in poor health at the insured's death and survive the insured by only a very short period, the election of the Life Income Option for the beneficiary would result in the loss of the fund set aside to purchase the deferred contingent instalments. If settlement with the primary beneficiary under this option is not compulsory but is left to her choice, this risk is somewhat alleviated.

Actuaries frown upon this practice upon the theory that a poor mortality experience would follow because of the resulting selection against the company. This view is reasonable if the rates quoted under the Life Income Option are based upon an ultimate instead of a select table. It should be remembered, however, that a certain amount of selection occurs when the beneficiary elects the Life Income Option after the insured's death, no previous election having been made, as in these circumstances a payee in poor health is not likely to elect the Life Income Option. The logical solution to the difficulties arising from the element of selection in the use of the Life Income Option might be reached by including two sets of rates in the option, one to be used when the insured elects the Life Income Option for the beneficiary to be effective after his death and the other to be used when this option is selected by the payee after maturity.

To offset adverse selection under the Life Income Option, many companies have modified their practice in permitting the beneficiary to elect this option at a subsequent date. Some will not permit the policyholder to give the beneficiary the right to elect this option at all; others restrict the time during which this privilege may be exercised to a definite period following the insured's death; still others permit this only on one specified date, such as on the beneficiary's sixtieth birthday. Very few companies will permit the beneficiary to have the right to exercise this privilege at any time. The effect of refusing to allow this at all is questionable in view of the selection which may be exercised by the beneficiary if no election was made prior to the insured's death, while the reduction in adverse selection through limiting this privilege to one specified date probably is not very great.

Provisions Involving Special Contingencies. Although income settlements may be applied toward several different purposes, the policyholder has no guarantee that the income will serve that purpose for which it was intended. Proceeds held to provide an income for the insured's wife might be put to a better use should she remarry, or proceeds intended to provide an education for a son would not be needed for that purpose should he not attend college at all through laziness, indifference or inability. The family income might prove larger than is needed through the addition of Social Security. Could the policyholder foresee such developments, he might be able to arrange his insurance estate far more effectively.

In order to forestall the possibility of such happening, the policyholder may wish to place upon the company the responsibility for the proper application of the income payments by the payee. To provide for a change in the settlement upon the occurrence of certain contingencies, such as these, places the company more in the position of a trustee. Generally speaking, such settlements are better arranged through a separate trust, although life insurance companies wish to be cooperative whenever feasible.

Income payable to the policyholder's wife often is intended primarily to provide an income for rearing his children, and there is no guarantee that the income will not be diverted into other channels should she remarry. To forestall this possibility, the policyholder may wish his wife to cease to receive benefits from the insurance after her remarriage. The justification for such an arrangement is questionable, but in some instances it may be desirable. A few companies do include such a provision.

The usual plan when this provision is requested is to terminate instalments to the wife upon notice of her remarriage and to continue them to the contingent beneficiaries in like manner as would have been the case had she died.[89] It should be noted that the termination of payments should not be contingent upon the actual marriage itself but upon receipt of suitable notice by the company. In this way the burden is shifted from the company to the contingent beneficiary, so that the former need not verify that the payee has not remarried before making each payment, nor can it be held liable for the continuance of payment to the wife through ignorance after she has remarried. On the other hand, should the wife contend that the notice of her remarriage was given the insurer fraudulently, the matter can be adjusted.

Most of the companies that include the remarriage provision at all limit its use to apply only to the wife of the insured. Many also will not allow this provision except when the children of the insured are designated as the contingent beneficiary. In any case this provision is not feasible for obvious reasons when the wife is receiving under the Life Income Option.

In order to guarantee that education proceeds will carry out their purpose, the company often is requested to insert

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[89] See suggested Remarriage Clause, Appendix A.19.

a provision in the agreement stipulating that the plan of payment will take effect only if the payee actually attends college. In carrying out such a settlement, the company would be construed as exercising trustee powers, as it would have the burden of determining what constituted a college and what constituted attendance. A barber college or a business school might be construed as an institution of higher learning, while enrollment for one course in the local university might be construed as attendance. Further difficulty arises if the company is required to determine the continuance of attendance before making each payment.

Such responsibilities are not the proper function of an insurance company, and it probably would be preferable that such settlement be effected through a separate trust. Although we do not recommend the practice, many companies have agreed to assume this additional burden in order to promote education as one of the functions of life insurance. When such provision is allowed, the agreement should state explicitly that the company shall be the sole judge of what constitutes attendance at college and that this decision shall not be made at its peril. If the clause is drawn in this way, there is little real guarantee to the policyholder that his wishes will be carried out, as he must rely solely upon the discretion of the company, and the company has no interest at stake other than to avoid a possible counter-claim. A more feasible plan is to have the education income commence upon the written authorization of some third party such as the insured's wife, his attorney, or some other trusted relative or associate.

With the development and ever increasing importance of Social Security, an effort has been made in life insurance programming to have the income from insurance proceeds tie in with the Social Security benefits. A particularly attractive program to the policyholder is one that combines the income from the life insurance and Social Security benefits to provide a level monthly income for the beneficiary. The use of settlement options alone will not always accomplish this, as a change in the Social Security Law or the family status of the beneficiary might alter the

Social Security income without a compensating change in the income from the life insurance.

To overcome this obstacle, it is desirable that the life insurance settlement be made more flexible. This can be achieved through the use of the Fixed Amount Option with a clause to the effect that the income will be reduced by the amount of any Social Security income that might be payable.[90] It should be noted, however, that the burden of determining the extent of the Social Security income should not be placed upon the company but upon the beneficiary.

Except for the remarriage and education provisions, life insurance companies prefer not to include clauses by which the plan of settlement depends upon the occurrence of some special event other than the death of the payee. The only exceptions generally allowed are situations where the plan of settlement depends upon the amount of the proceeds, the amount of income or the life of a third party. With reference to the first of these, many companies automatically include a provision by which amounts of less than $1,000.00 are paid in a single sum instead of under an option.[91] Another illustration of this procedure is found when an amount sufficient to procure a stipulated income under the Life Income Option is so applied and any balance is applied differently. Changes in the plan of settlement depending upon the income involve principally additional withdrawal privileges which become effective should the surplus interest allowed fall below a stipulated rate. None of these special provisions are of particular consequence.

When the plan of settlement depends upon whether or not a third party is living, an administrative problem may result. We have mentioned already the desirability for payment to a third party during the minority of a beneficiary, in which case the continuance of the income depends upon the life of an individual other than the payee. Another situation of this sort exists when the exercising of special privileges by the primary beneficiary depends upon

[90] See suggested Social Security Clause, Appendix A.20.
[91] See Article IV M of Appendix B.2.

whether or not the contingent beneficiary is living. The insured, for instance, may wish to withhold or limit withdrawals by his wife during the lifetime of the children. Usually no special difficulty results from such arrangement, but caution is warranted lest the company be confronted with an involved situation in administering the account which might defeat completely the purpose of the settlement.

The Common Disaster Clause: The Settlement Option Agreement provides that the proceeds shall be payable to the beneficiary provided she is living at the insured's death. In some instances this arrangement may defeat the purpose for which the insurance was procured, as would be the case where the insured had designated his wife as primary beneficiary and the insured and beneficiary died as the result of an automobile accident in which the insured was killed instantly, while his wife was rushed to the hospital where she died an hour later. In such a case the proceeds would be payable to the insured's wife, since she was living at his death, even though she would derive absolutely no benefit therefrom. If there were no children, the proceeds would accrue to her estate and so eventually to her family, even though they may be well off, and the insured's family would be deprived of any benefits therefrom, even though they may be in need of this protection. Even if there were children who would inherit the major portion of the wife's estate, the insurance proceeds accruing to them in this way would be subject to state inheritance taxes, while otherwise they might be exempt.

To overcome such a situation an additional clause, known as the *Common Disaster Clause,* may be included in the policy or in the beneficiary designation form upon request. This clause provides that payment of the claim will be deferred for a specified period, usually thirty days. Should the beneficiary die during that period, settlement will be in like manner as would have been the case had the beneficiary predeceased the insured. By the inclusion of this provision the proceeds will have a much better chance of passing to those individuals whom the insured wished to benefit, even though he and the primary beneficiary may die in a common disaster, but it should be remembered that in all cases payment of the claim will be deferred.[92]

This clause is of little real effect if the proceeds are to be held under a settlement option and is of more real value when settlement with the primary beneficiary is to be in a single sum. When a contingent beneficiary is named under an income settlement, the contingent beneficiary will ultimately receive the proceeds in any event, and the Common Disaster Clause will take effect only in the event the insured, all the primary beneficiaries and all the contingent beneficiaries should die as the result of a common disaster. An exception to this principle is to be found, however, when the Life Income Option is elected, because when the primary beneficiary survives the insured by only a very short interval, the contingent beneficiary would be deprived altogether of that portion of the fund which was credited to the Contingent Instalment Account and would receive only the guaranteed instalments. It is advisable to include this clause when the Life Income Option is elected.

Election by the Payee After Maturity. Our discussion so far has been confined mainly to an election made by the insured to become effective after his death. If no such election is made, the settlement option privilege is available to the beneficiary upon payment of the death claim proceeds. Insofar as the provisions of the policy, the accounting procedure and the preparation of the agreement are concerned, there is little difference between an election made by the insured to become effective for the beneficiary at a later date and an election made by the beneficiary or payee after death or maturity, except that in the latter case the agreement is much simpler, as there is no need for providing for disposition of the funds should the primary beneficiary not be living. The two situations warrant individual consideration mainly because the legal aspect and the attitude taken by the life insurance companies in each case is different.

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[92] See Article III D of Appendix B.2.

As regards the legal aspect, the insured in completing the election is disposing of proceeds which are not his own property and which he never will be able to use for his own benefit, nor are the proceeds always the absolute property of the primary beneficiary. If a settlement option is elected, the primary beneficiary has only a life interest in the proceeds to the extent of the income provided, the contingent beneficiary having an interest depending upon a condition precedent. This situation arises through permitting the insured to designate a primary beneficiary and a contingent beneficiary to receive income, the latter to receive the balance of the income payable after the former's death.

On the other hand, when the beneficiary makes an election after the insured's death or when the owner of the policy makes an election at maturity or upon surrender, the election does not pertain to an indefinite fund payable at some future date, from which the person making the election will realize no personal advantage, but rather to a definite fund that is payable immediately, or which theoretically already has been paid. The person making the election is disposing of proceeds which are his absolute property and which he could use immediately entirely as he wished. The election is not a provision for payment of income to a third party but is really an investment by the owner for his own benefit. A similar situation may be said to exist when ownership vests in the beneficiary and the beneficiary is making an election for her own benefit to take effect at the insured's death. The situation here differs from an election after maturity only in that the proceeds will not be payable until some indefinite future date, but in both instances the election is made by the person having full ownership of the proceeds.

It follows, then, that the electing payee cannot impose upon himself the restrictions that the insured could impose upon the beneficiary. For example, he could not relinquish the right of withdrawal if conferred by the policy provisions except by transferring to a third party a special interest in the funds, unless the relinquishing of this right were for a consideration such as a more favorable surplus interest return. If no such factors were present, it is questionable whether such surrender of rights by the payee could be enforced.

A more serious question arises when the electing payee wishes to designate a beneficiary to take any balance which may be due at the payee's death. It is believed by some authorities, with ample supporting legal evidence,[93] none of which, however, is directly in point, that such a designation is tantamount to a testamentary disposition and is not valid because it does not conform to the testamentary procedure prescribed by law. To forestall the possibility that the courts will interpret the contract in this way, many companies will not permit the naming of a beneficiary by the payee unless the beneficiary so named acquires an immediate interest in the fund. This is achieved through a provision in the supplementary contract to the effect that the payee may not make withdrawals from the principal or change the beneficiary without the written consent of the beneficiary that is designated.[94]

The deferred settlement of life insurance proceeds is a relatively recent innovation, so that its precise legal status has not been fully determined, although the one case directly in point[95] supports the naming of a beneficiary by the electing payee upon the theory that the beneficiary is entitled to recover as a third-party-donee-beneficiary. In this case it is held that the right of the beneficiary to collect the proceeds at the payee's death is based upon a contractual obligation and not upon any interest in the property of the decedent, so that the Statute of Wills does not apply. Whether in subsequent decisions the courts will sustain this view is a matter for conjecture, but to date the evidence is that they will.[96] Since an adverse court decision might upset many deferred settlement contracts now in existence and since a definite precedent has been

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[93] See Appendix A.21.

[94] In Appendix B.3 note how the right of withdrawal is limited if Mode A is elected.

[95] Mutual Benefit v. Ellis, 6 Life Cases, 958; 125 Fed. (2) 127.

[96] Kansas City Life v. Rainey, 10 Life Cases, 206.

set by the few cases in point, it is reasonable to assume that the present trend will continue.

While the courts may tend to take a liberal view on this question, it is questionable whether the life insurance companies will wish to liberalize their practice. The Settlement Option Rider contains no definite provisions with reference to the naming of contingent payees, so that the company may limit such designations in any manner it chooses. It appears reasonable to assume that the company has fully discharged its social obligation upon settlement with the dependents of the insured and that it owes no obligation to the dependents of the beneficiary. Consequently, many companies will permit the insured to provide for many more contingencies and to include many more special provisions in a Settlement Option Agreement to take effect at his death than they will permit in the case of an election by the payee after maturity. While there is no practical objection, aside from the legal aspect, to permitting the electing payee after maturity to name a beneficiary to take in a single sum any balance remaining after the payee's death, there appears to be little justification for further liberality.

Transfer of Ownership. A Settlement Option Agreement is a title document to the extent that it constitutes a beneficiary designation. Such being the case, it is advisable, to avoid any possible future conflict, that a clause be incorporated in the agreement by which the insured continues to have all rights under the policy including the right to change the beneficiary and the right on his sole signature to assign the beneficiary's interest.[97]

Occasionally the insured may wish to modify these rights by relinquishing them altogether, by transferring them to the beneficiary or by reserving them subject to the consent of the beneficiary during her lifetime. Such modifications if permissible tend to becloud the title. In any event, it should be borne in mind that an absolute transfer of ownership cannot be accomplished through a

[97] See Article III B of Appendix B.2.

Settlement Option Agreement, but must be accomplished through an assignment.

This brings us to the general question of the combination of a deferred settlement election with a transfer of rights or ownership. Such a combination usually is prompted by a desire to protect the beneficiary against the future actions of the insured or by a desire to remove the insurance from the insured's estate, so that it will not be subject to estate taxes at his death. Under present Federal estate tax laws it is almost impossible to achieve the latter objective through a transfer of ownership.[98]

The combination of a transfer of title and a settlement option election, gives rise to legal problems. This procedure is a questionable one, and one into which the policyholder should venture only with extreme caution and with the best legal advice obtainable. There are five methods in general use by which a settlement option election and a transfer of title may be combined, but all of these methods have their limitations, none being ideal, and the method best suited to each individual case depends upon the end to be achieved.

One method involves including in the agreement the clause already mentioned by which the beneficiary during her lifetime must consent to any subsequent action of the insured. This procedure in effect places ownership of the policy jointly in the policyholder and the beneficiary during their lifetime, the beneficiary acquiring the equivalent of a vested lifetime interest. It affords an excellent means of guaranteeing the beneficiary's rights, but it is not a transfer of ownership, nor does it completely restrict the rights of the insured.

A second method is to provide in the Settlement Option Agreement that the insured relinquishes all incidents of ownership of the policy, or that all rights may be exercised solely by the beneficiary. This plan often is desired upon the theory that the insured can avoid the gift tax because there is no actual transfer of the policy. Since there is no transfer of ownership while at the same time all rights

[98] See Appendix A.22.

definitely are transferred, it is held by some authorities that the transferee becomes merely the agent or attorney for the insured, as he acquires powers rather than property.

A third method involves an absolute assignment in the usual manner to the primary beneficiary, who then may make the election. This method is by far the most satisfactory if ownership is to be transferred. The objections to this plan lie in the possibility of the prior death of the assignee and in the fact that the assignee may at any time revoke the plan of settlement or may even refuse to sign the settlement option agreement after acquiring ownership.

Should the assignee predecease the insured, the policy then becomes the property of her estate, and its cash value should then be claimed by her executors or administrators, unless special provision had been included in her will for its disposition. Attempts to offset this difficulty have been made by including in the assignment a provision for successive assignees, so that the absolute assignee has only a life interest in the policy, the assignment providing that at his death, the assignee's interest will pass to a designated third party. Authorities differ upon the legality of such a procedure, and those favoring it proceed upon the assumption that an assignment is merely a conferring of rights which if not exercised may pass to a third party, while those who oppose this practice proceed upon the theory that property can be transferred only through a testamentary disposition. In any event such procedure should be discouraged as complicated and subject to possible controversy.[99]

The disadvantage that the beneficiary by this method acquires full title may be offset by including in the agreement which she is to sign a clause by which her rights under the contract may be exercised only with the written consent of the contingent beneficiary or some other third party. If this party is a minor, it will be impossible for the beneficiary to revoke the agreement for several years to come, at least.

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[99] See Appendix A.23.

A fourth method is to assign the policy to a third party who may then make the election. The assignee under this arrangement may or may not act as a trustee. This plan is of advantage in that the policyholder has transferred all rights without the beneficiary acquiring any, but is of disadvantage in that the assignor has no guarantee that the assignee will represent his interest properly unless the latter is bound by a trust agreement previously executed. Generally speaking, this method is very similar to that previously discussed.

The fifth and final method employed is for the insured to execute the Settlement Option Agreement and then assign the policy, the advantage being that the election is placed in effect and further action is not required by the beneficiary, who need not be advised of the transaction at all. This method obviously will not apply in cases where the policy specifically stipulates that the insured may assign the interest of the beneficiary, and even if such provision were not in the policy, the subsequent assignment might be held as tantamount to a change of beneficiary, revoking the previous election.[100] Generally speaking, this method is the least desirable of the five.

Prior to the passage of the Revenue Act of 1942 the question of the proper method of transferring ownership and title was a paramount issue. Under the current act, however, this issue loses most of its importance, as there appears to be no satisfactory method by which the insured can remove any part of the insurance from his estate insofar as estate taxes are concerned if he had any incident of ownership in the policy at any time after January 10, 1941. Insurance advisors find themselves in the unprecedented position of advising policyholders to surrender policies which they may have carried for many years and in which they may have accrued considerable value to be replaced by new insurance to be applied for by some third party if the estate tax upon the insurance is sufficient to justify the loss resulting from such procedure. The only way in which the insured can transfer present insurance out of his estate

[100] See Appendix A.24.

is to make a transfer for a consideration, and when this is done the beneficiary at the insured's death is subject to income tax on any resulting profit from this transaction.[101]

It might seem that we have given too much consideration to the subject of transfer of ownership in view of the continuously stricter tax laws. The only possible tax advantage of a transfer of ownership lies in the possibility of eliminating state inheritance taxes at the insured's death, but the advisability of such action depends upon the prevailing law in the jurisdiction in which the insured resides. Transfers of ownership may, however, involve considerations other than the tax angle.

The Settlement Option Agreement Problems Generalized. In this and the preceding chapter we have discussed many of the problems arising in conjunction with the preparation of Settlement Option Agreements. A detailed discussion of every situation that may be encountered is far too involved to be covered here. As a guide to the practice to be followed by life insurance companies in dealing with unusual settlement option requests, and as a possible assistance to agents who are confronted with an unusual settlement problem, we shall outline some of the factors which have a bearing upon the general problem.

The Settlement Option Agreement is the material manifestation of the exercising of the settlement option privilege in the policy, and its provisions evolve from the provisions of the Settlement Option Rider. The company may not refuse to incorporate in the agreement any provision permitted by this section of the policy, but it is not obligated to incorporate therein special provisions not covered by the contract. Such additional provisions, however, have been inserted in the agreement in an effort to enable the policyholder to arrange a more complete program, to meet competition, or to make possible the placing of insurance which otherwise could not be sold.

The Settlement Option Rider is absolutely silent upon many points that are brought up in connection with the

[101] See Appendix A.22.

preparation of Settlement Option Agreements. There are, for example, rarely any provisions permitting the naming of a contingent beneficiary or the electing of more than one option; on the other hand, there is no specific provision prohibiting such practice. There are very few specific prohibitions in the Settlement Option Rider, so that whether or not certain provisions will be incorporated in the Settlement Option Agreement depends entirely upon the extent to which the company wishes to accommodate the agent and policyholder. The question thus arises as to the extent to which the company should go in this respect. Since the apparent wish of most insurance companies is to be as liberal as they can, the question evolves into a consideration of what practices, if any, might result disadvantageously to them should they go too far.

There are four factors, any one of which might cause the company to object to the inclusion of certain provisions. These factors are either legal, administrative, investment or actuarial in nature. Every unusual request should be considered in the light of these four factors, and if there appear to be no features that are objectionable to the company, the request, as a general rule, will not be allowed.

In this connection the greatest stress probably is placed upon the legal issues because of the fact that the Settlement Option Agreement is in the nature of a legal document. To do so is a mistake, in our opinion, because the legal issues are so vague that authorities differ as to the extent of their effect, if any. There are two bases for legal objection: either the request is definitely contrary to statutes, or it may in certain circumstances render settlement difficult.

With reference to the specific application of statutory provisions to the terms of the Settlement Option Agreement, authorities again are not in accord. There are no statutes specifically prohibiting Settlement Option Agreement provisions, so that the only theory upon which provision may be denied is that there is no statute giving life insurance companies that power. Some authorities maintain that an agreement whose provisions are contrary to the law against perpetuities, the law against accumulations or the law pertaining to restraints on alienation could be held as illegal, but other authorities maintain that these laws do not pertain to deferred settlement of life insurance proceeds.[102] In any case, the company should not stand to lose directly through violation of these principles, since, if the agreement were held to be illegal and of no effect, the company merely would be required to pay the proceeds at once. A word of caution to the insured and agent regarding these issues, however, is advised.

Other laws which might have a bearing upon life insurance settlements are the testamentary or probate laws, the laws pertaining to transactions with minors and the laws pertaining to trusts, gifts or agencies. We have already discussed the difficulties which might result from endeavoring to reopen an estate to receive insurance proceeds after it has been closed. We have also discussed the problems arising in connection with settlements with minors and trustees. As a general rule, we may state in this connection that, although a certain method of settlement might be contrary to law, this should not result in a loss to the company if due caution is exercised before making payment.[103] The parties to suffer are those whom the policyholder intended to benefit, because if they are able to collect at all it may be only after considerable expense and delay.

The real legal difficulty arising in the preparation of the Settlement Option Agreement lies in the possible ambiguity of its own provisions. The intentions of the policyholder should be expressed clearly and not be subject to possible dual interpretation. The inclusion of irregular or unusual provisions presents a problem, not because the provisions may be contrary to law, but because the language may be so vague that it may be difficult to interpret just what was intended. Such conditions may result in a contest, and, unless the company can interplead the case, it must run the risk of double liability in either of which cases it runs the risk of having on its books a dissatisfied client.

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[102] See Appendix A.15.
[103] See Appendix A.18.

We have mentioned legal and administrative difficulties as two of the limiting factors, but some overlapping is to be found between these two. Administrative difficulties may result from legal problems, as in the case of adverse claims. Another illustration of administrative difficulties with legal significance is the remarriage or attendance at college provisions, unless the provisions are so worded as to reduce the responsibility of the company to a minimum. Another administrative problem exists for the company if numerous remote beneficiaries were designated, particularly if they were unborn when the settlement was elected. Under such circumstances it must locate all the beneficiaries before payment may be made, and failure to do so may result in litigation later. Provision for payment to the unborn children of the insured's sister, for example, might be extremely difficult should payment not be due until forty years after her death, since it would be necessary to ascertain the number of children she had, to find out how many are living and to locate them even though they may reside in distant parts.

Administrative difficulties also may involve accounting features; this situation is encountered in the case of irregular settlements which are not in accordance with the provisions of any of the options in the policy. In some instances such requests may involve no real difficulty at all, while in others the difficulty may be practically insurmountable.[104] Payment of instalments of varying amounts or on irregular dates are troublesome unless a special routine has been established to take care of all such irregular accounts.[105] Also, settlements involving a large number of obligatory changes are burdensome and expensive to operate. Likewise, a settlement involving the payment of very small incomes to a large number of income payees is expensive to administer. All such problems might be minimized or even avoided altogether through proper restriction of the provisions of the agreement.

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[104] See Appendix A.25.

[105] The next chapter deals with the periodical payment routine.

When we consider the question of administrative expense, we should not overlook the very important item of the cost of preparing the Settlement Option Agreement itself. The preparation of a long and complicated agreement is expensive to the company, since this service is rendered without extra charge to the policyholder. It is necessary first to interpret the request; it then may be necessary to draft a rough outline before dictating the terms of the agreement itself; if the agreement is long, the actual dictating consumes time; the agreement, when dictated, must be typed; then it must be checked; any errors that are found must be corrected, and serious errors may necessitate the retyping of the entire agreement. All of these functions consume many valuable clerical hours. The fee charged by a practicing attorney for a similar service might be quite high.

In extreme cases the company is justified in eliminating provisions to which there is no objection if their inclusion would render the agreement so long and difficult to prepare that its cost would be excessive. Complicated provisions for settlement with contingent beneficiaries are often of little benefit to anyone, yet, as we have seen they increase greatly the length of the agreement and the cost of its preparation. From the point of view of equity it would be wrong to undertake a settlement which would be difficult and expensive to administer, especially under a small policy, where the company would be providing for one group of policyholders a costly service at the expense of the others. It follows that the company should exercise some discretion in eliminating such provisions.

Just as the life insurance contract is fundamentally one of long duration, the Supplementary Contract is equally so. In cases where the proceeds are retained for beneficiaries who are very young, they may be retained for as long as three or even four generations. During this period the insurer must be able to invest the proceeds to provide a return at least equivalent to the interest guaranteed to the payee. If the proceeds are subject to withdrawal, the situation is even more serious, as probably the withdrawal rate will be greater in the time of low cash balances. To rectify these situations, some companies will guarantee a higher interest on funds retained under options which by their terms are not withdrawable. The possible future investment problems should not be overlooked in determining the company's policies with regard to Settlement Option Elections. We have already discussed the restrictions which might be imposed to limit the maximum period of retention.

The actuarial problems involve mainly settlement under options involving life contingencies. The company is justified in eliminating from the agreement any provision which gives the payee the right to select against the company in electing one of these options in a manner not contemplated in calculating the income payable thereunder.[106] A further actuarial problem arises in the valuing of the accounts payable under the instalment options.[107] An administrative problem is created when an irregularity under one of these options which is of such a nature that the account must be valued separately is allowed. For this reason the company is justified in refusing variations in the period of instalments certain, even though such variation may present no other problem.

Of these four considerations—the legal, administrative, investment and actuarial aspects of the situation—the administrative is the one requiring the greatest amount of individual consideration. The investment and actuarial objections apply to only a very few settlements and can be eliminated altogether through the adoption of sound company rules and practices in the preparation of Settlement Option Agreements. The legal problems involve primarily using clear and unequivocal language in the provisions of the agreement. The administrative considerations apply more generally, and each case should be considered in the light of the following two questions: will the agreement be too long, complicated and intricate to justify its preparation, and will the administration of its provisions involve difficulty and possible ambiguity?

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[106] See discussion, pages 75-77.
[107] See discussion, pages 103-104.

CHAPTER VI

THE PERIODICAL PAYMENT ROUTINE

Life Insurance income settlements involve the payment of equal periodical instalments which are payable either monthly, quarterly, semi-annually or annually. Because of the fact that there is only occasional and well-defined variation if any at all in the amount of the instalments as they become due and because of the fact that they are payable at definite intervals, the administration of such payments can be greatly simplified through an adequate routine by which all similar accounts are grouped together and handled as one unit.

With the tremendous increase during recent years in the supplementary contract and annuity accounts,[108] considerable thought has been given to the methods by which the payments thereunder may be more efficiently administered. It is with some hesitation, therefore, that we undertake a discussion of this phase of income settlements, since anything we might say here may shortly become obsolete through further improvements during the ensuing post-war years. For this reason we shall confine our discussion more to general principles than to the details of operation.

The periodical payment routine involves three essential steps: the preparation of the check, the accounting procedure and the mailing of the payment to the payee. While disability is a subject beyond the scope of this text, the disability payments under annuity and waiver clauses may be incorporated into the system for making payments under settlement options, income policies and annuities, as the same problems are encountered.

The Preparation of the Check. While the account is payable only at the home office, it would be most incon-

[108] See page 4.

venient for the payee to be compelled to go to the home office to collect each instalment in currency or otherwise as it became due. It is more satisfactory to all parties concerned that payment be made by check or draft. Obviously a standardized form of check should be used for this purpose. Printed thereon may be the company's name and the bank at which it is payable, and inserted therein the amount, the payee and the due date. The check may be signed personally by an authorized employee of the company or a signature may be printed thereon. If personally signed, the use of a check-signing machine is recommended as a labor- and time-saving device. To maintain the desired uniformity in the check and to simplify the banking procedure, it is convenient to have the numerous smaller periodical payments, at least, payable by draft at the same bank, so that the company can present one check daily to the collecting agency to cover all the items that have been presented for payment. The check should have attached to it a statement of the account to which it is debited, which statement may be detached and retained by the payee.

A further important requisite is that the check be endorsed in such a manner as to fully protect the company. Not only should the endorsement acknowledge receipt of payment, but it should guarantee that the payment is due. Annuity payments, for example, are contingent upon the life of the annuitant. The personal endorsement of the payee or his duly appointed representative usually is required, and a statement to this effect should be included in the endorsement. The following or a similar endorsement is recommended: "This check is issued on the condition that the payee is living on the due date and is entitled to payment. This check is not to be cashed or deposited before the due date and must be personally endorsed by each payee or his or her personal representative."

There are several methods in use by which periodical payment checks may be prepared: Among other methods they may be typed individually as they become due; they may be prepared in bulk for each successive day through use of the addressograph; or they may be prepared periodically through use of punch cards. The individual typing of each item is laborious, expensive and subject to greater error. Except in the case of a very small company, it is recommended that the checks be prepared automatically by machine.

The addressograph is of advantage through the resulting saving of time and labor and the assurance of greater accuracy. After the original plate has been prepared and verified little difficulty is encountered in the preparation of subsequent checks as long as there are no changes in the subsequent status of the account. Only a moderate expense is required for the installation of the necessary equipment, but the functions of the machine are definitely limited to the preparation of the checks.

The system involves briefly the maintenance of an addressograph plate or stencil for each account, these stencils being filed in a special cabinet. Engraved upon the stencil is the name of the payee, his address, the amount of the check, the account number and possibly the account to which the payment is debited. Through the use of the addressograph machine the data upon the addressograph plate is inserted into the company's blank check form. Since each successive periodical check resembles the preceding check, except for its date, a stencil, once prepared, may be used over and over again for the preparation of each subsequent check. A limited number of changes may be made in the original stencil to take care of subsequent changes in the account, so that it is unnecessary that a new stencil be prepared with each change. The check, when finished, has much the same appearance as one that has been prepared on a typewriter, except that the data may be more compact.

The use of punch cards is preferable, because in addition to preparing the checks, the machine can total the daily disbursements to be debited to the ledger accounts. This method is of further advantage in that statistical data can be assembled readily if desired, and tax statements required by Federal Government and the various states can be prepared more efficiently.[109] Through the use of machines an accurate control can be maintained upon all the Supplementary Contract Accounts. The disadvantages of this method are that the equipment is extremely expensive and the routine extremely intricate and involved.

The punch card system involves the maintenance of a master punched card for each account, which together with name and address cards contains all necessary information. The payee number, the policy number, the amount on deposit, if any, and the amount of the basic instalment are carried on the master card together with coded information showing in sufficient detail the nature of the account and the mode of payment. From this card an account card is prepared on the reproducing punch with the issuance of each check, and this account card is collated with the name and address card according to the mode of payment and the payee number. A check is prepared by the alphabetical machine on the company's check form for all items due on the same date for each payee.

Although because of its greater complexity, the chances for errors are greater under this system, this is compensated for by the superior check maintained which enables these errors to be found and corrected before serious damage is done. In order that the system may operate effectively there must be an efficient method by which new accounts are set up and by which all changes in the account are noted promptly.

The Accounting Procedure. In order to have a permanent record of all the accounting transactions in connection with income settlements it seems feasible to maintain a separate card record [110] for each account. This record, often referred to as the payment card, may serve the dual function of ledger account card and history card. It also may be used to verify each payment as it becomes due.

Upon this card may be stated the name of the payee, the policy number, the payee number, the address, the original date of entry, the manner of payment, whether monthly or

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[109] See discussion of taxes on pages 105-108.
[110] See Appendix B.4.

quarterly, etc., the due date of each payment and the amount of each periodical payment broken down by separate accounts, if a portion of the payment is to be charged to surplus interest. In addition this card should contain a complete record of all financial transactions pertaining to the account. The cards used for payments under the settlement options should show for ready reference the guaranteed rate of interest, the current rate of surplus interest allowed, the origin of the account such as by death, maturity, surrender or otherwise, the person making the election, whether the insured or the payee, the form of Supplementary Contract outstanding, whether the policy, a special Supplementary Contract form or a Deposit Receipt and, finally, whether or not the account is subject to withdrawal or commutation. In addition in the case of instalment accounts the card should show the number of instalments certain, the due date of the final instalment, the amount and due date of the single sum payment under the Family Income Policy or the Instalment Bond Option, and possibly some information with reference to the extent to which the income is taxable. The card used for interest payments should show all withdrawals from the principal, the balance on deposit and the resulting change in interest due. The card used for Fixed Amount Option Payments should be balanced periodically to show the amount on deposit and all interest credited thereto. The Annuity Payment Card should show the type of annuity, the extent to which annuity payments are taxable and the nature of the certain instalments, if any, that are payable.

When the checks have been prepared, they may be compared with the payment cards for verification and entry. The payment cards should be filed in such order that the checks when prepared will be in proper order for comparison. A separation according to the period of payment and according to the due date is necessary. If the items on the check agree with those on the payment card, the due date is entered upon the check. The current date is recorded upon the payment card as evidence of the disbursement.

The verification of the checks through comparison with the payment card and the entry of each payment is an arduous procedure requiring extreme care and accuracy. When the checks are prepared by punch cards this step may be eliminated altogether by treating each day's payments as a single unit. This is achieved through the maintenance of a Control Card,[111] upon which is indicated the basic amount of the periodical payments that are due. If this total agrees with the sum of the checks that are prepared as indicated by the punch card tabulation, it follows that the entire group of checks are accurate.

This system involves the maintenance of a separate Control Card for each day of the year.[112] Whenever a new account is created or a present account terminated, the amount of its basic income is added to or subtracted from the basic total for the date upon which it is due through proper entry upon the Control Card for that date. Accounts requiring special attention may be indicated through special memoranda. The total payments actually made are indicated through one entry upon the Control Card instead of by individual entry on each Payment Card involved. Consequently the Payment Card no longer reflects a complete record of all payments made under the account and is used only to indicate those payments which are outside of the periodical payment routine.

When the checks have been prepared and the payment verified, the final step to complete the accounting procedure is the entry of the total disbursements in the cash book together with a debiting entry to the proper account. The manner in which this is accomplished would depend upon the general accounting procedure of the company.

From the foregoing discussion it can readily be seen that the periodical payment routine is not at all adapted to irregular plans of payment. Because of the large number of accounts that they are handling, life insurance companies are justified in refusing to prepare Settlement

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[111] See Appendix B.5.

[112] It may be more feasible to keep separate totals for monthly, quarterly, semi-annual and annual payments.

Option Agreements under which the payments could not be administered through the periodical payment routine.

Mailing. The mailing of the check to the payee completes the periodical payment routine. Periodical payment checks may be sent in bulk to the branch offices for delivery or they may be mailed to the payee directly from the home office. When they are sent to the branch office for delivery, the home office is relieved of any further responsibility as to the final mailing.

Sending the checks to the branch office is of advantage in that it enables the agent to render better service to the payee, and in rare instances the soliciting agent may find it of advantage to deliver each check personally. More often the advantages accruing in a few instances from mailing through the branch offices are more than offset by the disadvantages. Personal delivery on a large scale would consume far too much of the agent's time, so that a large volume of the checks would be remailed from the branch office. This is not only cumbersome but entails additional expense. It has been found preferable that the bulk of the checks be mailed from the home office, and only those be sent to the branch office for personal delivery in special instances where this arrangement is preferable.

If the checks are to be mailed from the home office, it is necessary that the home office have accurate up-to-date information as to the payee's address. The window envelope is a convenient device in this connection if the address appears upon the check. Its use saves time and promotes accuracy, since it is unnecessary that the envelope be prepared separately, nor is it necessary that the check and envelope be matched. It is necessary, however, that the check be fitted in the envelope so that only the name and address and not the amount or other data show through the window.

In the interest of additional service to their clients, life insurance companies endeavor to have all periodical payment checks in the payees' hands upon the dates they become due, although the insurer is under no legal obligation in this respect.[118] To achieve this, checks must be mailed in advance of their due dates, and those going to the payees residing in more distant parts must be mailed sooner than those going to payees who reside nearer at hand. All checks due on a particular date must be staggered depending upon the geographical location of the payee, unless the mailing date instead of the due date is taken as the date for preparing the check.

Payments to local payees may be sent one day in advance; those going to distant parts of the country, such as from New York to the west coast, may be sent five days in advance; all other items may be sent three days in advance, as the receipt of a few items a day in advance is probably preferable to the burden of further division. Special consideration to payees residing in foreign countries is not warranted unless the company specializes in a large foreign business.

An alternative procedure to staggering the checks for mailing purposes according to their destination might be to mail all checks five days in advance to their due dates. This is done upon the theory that the check, though received far in advance in some cases, may not be presented for payment until it is due. This method, however, does not work in practice, because the responsibility is placed upon the payee's bank to see that the items are not presented in advance, so that many items are presented to the company for payment before they are due.

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[118] It is sufficient that the checks be placed in the mail upon their due dates.

CHAPTER VII

OTHER INCOME SETTLEMENT ADMINISTRATION PROBLEMS

The Supplementary Contract is a relatively new life insurance function, so that all its implications are not completely understood. It is difficult to evaluate correctly all the problems which have been anticipated. Future court decisions, new legislation and our changing conception of our social obligations may give birth to new problems which have not been foreseen at all. Consequently, as in the case of the periodical payment routine, our discussion of the problems arising in the administration of income settlements is by no means comprehensive. In the preceding chapter we discussed the general routine by which periodical income payments are made, and in this chapter we shall discuss some of the irregular problems that come up from time to time.

The Valuation of the Accounts. All policy deposits [114] are carried on the ledger accounts of the company, and any change in the status of these accounts is effected through a journal entry, so that the valuation of this account is a function of the Auditing, Accounting or Comptroller's Department. The status of each individual account at all times should be ascertainable from the payment care; the total balance can be ascertained from the ledger account.

The valuation of future annuities and contingent instalments cannot be achieved in this way, as the extent of future payment cannot be determined in advance. These accounts are valued upon the reserve basis, and the calculation and maintenance of these reserves is an actuarial function. Future instalments certain also are valued upon this basis in order to eliminate the confusing relationship between principal and interest.

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[114] Settlements under the interest and fixed amount options.

Because of the fact that the payment of the annuity and instalment accounts and their valuation are usually handled in independent departments, it is essential that some system be devised by which the Actuarial Department be advised of all transactions affecting the reserves for these accounts if they are to bear an intelligent relationship to the payments made. A periodical check and balance between the two departments is advisable.

Assignments. Question arises as to the extent to which Supplementary Contracts are assignable. As we have seen, the Spendthrift Clause by its terms renders the proceeds unassignable in the absence of any statutes to the contrary, so that the Supplementary Contract which includes this provision should not be assigned. Contracts not containing the Spendthrift provisions and contracts involving elections by the owner of the funds, on the other hand, generally are considered as assignable.

An absolute assignment of the contract may involve awkward considerations. For one thing, the assignee acquires only the privileges that the assignor had, so that the period during which the assignee may receive income is definitely limited to the lifetime of the assignor. The company cannot be compelled to hold the fund for a longer period if it does not wish to do so. Furthermore, if the assignee is a corporation or an individual for whom the settlement option privilege was not intended, the company is justified in endeavoring to close the matter by requiring that the funds be commuted and taken by the assignee in a single sum.

Under a creditor assignment the instrument should indicate clearly to whom payments are to be made. It may be intended that the assignee receive the entire income payments, only a special portion of each payment or none of them, having only a prior claim upon the principal sum. Because of the variation in conditions that may be met, it is often preferable that the assignment form be prepared by the interested parties, although a form submitted by the company similar to that used in conjunction with life policies, if such form is available, may apply in a few cases. All contingent payees should join in the execution of an assignment, as the primary payee does not usually have the right to assign a contingent payee's interest.

Income Tax Reports. The periodical income payments under Supplementary Contracts and annuities afford an abundant source of income and such income, at least to the extent that it represents the payment of interest, is taxable. The Federal Government and the governments of most of the states have readily taken advantage of the revenue available by taxing income from this source. The tax officials can verify readily the amount of income and the extent to which it is taxable through the life insurance companies' accounts. In order that the government may have the necessary information to collect such taxes, the life insurance companies are required to report the taxable payments which they have made. Such reports are required annually and are due on specified dates between January 30 and May 15, depending upon the jurisdiction requiring them. The extent and nature of the information required varies with each state.

The Federal Government requires that the companies report all instances where the total taxable income paid to policyholders and payees exceeds Five Hundred ($500.00) Dollars. Such reports include all interest paid or credited, the taxable portion of all annuity payments, the taxable portion of all payments from the instalment account and the taxable portion of an endowment maturity proceeds. In passing, we wish to point out again that endowment maturity proceeds are taxable to the extent that they are in excess of the net premiums paid [115] unless they are to be left with the company under an option that is not withdrawable nor commutable.

Interest allowed during the current year is taxable in its entirety. This applies under the Interest Option whether the interest is paid or allowed to accumulate, unless the accumulating interest is not withdrawable, in which case there is said to be no constructive receipt. All interest

[115] See Appendix A.26.

thus accumulated, however, does become taxable in the year in which it becomes payable or withdrawable.

Annuity payments are taxable to the extent that they represent three (3%) percent of the net premiums paid. Under Deferred Annuities the cost is the net premiums paid and never the value at maturity or conversion. Under a Joint and Survivorship Annuity the income is taxable to each of the annuitants to the extent that they respectively contributed to its cost. If the annuity was purchased as part of a company pension plan, the cost is determined by the actual contribution of the employee if the plan is contributory,[116] but if the total cost is borne by the employer, the total payment is taxable. When the total of the exempted portions of each payment equals the original cost, the payments are taxable in their entirety, but prior to January 1, 1934, annuity payments were entirely exempt from tax until their total equaled the cost, a factor that must be considered in determining the date when the total payments become taxable. In the case of refund annuities or other annuities involving certain payments, any amounts due the beneficiary are taxable only after the exempted payments to the annuitant together with the payments to the beneficiary equals the total cost.

The formula for determining the extent to which instalment payments are taxable is more complex. Where endowment maturity or cash surrender proceeds are to be paid under the Fixed Period, Life Income or Instalment Bond Options, the instalments are taxable only to the extent that they represent three percent (3%) of the base cost—that is, the total net premiums paid[117]—until such time as the total of the tax exempt portion of each instalment equals the base cost, when the entire instalments become taxable.

Death claim proceeds payable to the beneficiary in instalments were originally taxable under formula to the

[116] See page 32.

[117] Under a recent ruling the net cash surrender value may be taken if less than the total net premiums paid.

extent that such instalments exceeded the original proceeds. Several decisions, however, subsequently confirmed by the Treasury Department,[118] held that instalment settlements chosen by the insured were wholly exempt. This position was later modified to apply to all instalment settlements resulting from death claims.[119] As a result, no tax is payable, nor are life insurance companies required to report to the Federal Government instalments payable under the Fixed Period, Life Income or Instalment Bond Options, or under Family Income, Continuous Instalment or other policies payable in instalments at the insured's death. It should be noted that this ruling does not apply to interest payable under the Interest Option, and whether or not at the present writing interest credited under the Fixed Amount Option resulting from death claims is reportable or subject to tax is not entirely clear, though there is authority [120] to support the position that it is not.

In a general way those states which require income reports from the source follow the formula used by the Federal Government. Many states, however, consider annuity and instalment payments as wholly exempt. Many states also have not made the distinction that the Federal Government has regarding the source of instalment payments and require that all such items be reported. A detailed statement of the items that the life insurance companies are required to report to the various states will be found in Appendix C.1.

The excessive growth of Supplementary Contract Payments and the increasing complexities of tax demands have placed a tremendous burden and expense upon life insurance companies. The devising of the most satisfactory system to meet this problem warrants special study. This problem has become particularly acute because of the recent reduction in the income exempt from Federal Income

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[118] See list of pertinent cases, Appendix A.26 and Treasury Decision 5231.

[119] Katherine C. Pierce v. Commissioner, 2 Tax Court No. 106, Oct. 4, 1943, and Treasury Decision 5515, approved May 16, 1946.

[120] The Joint Information at Source Committee of the American Life Convention.

Tax, so that the number of periodical income payees subject to such tax has increased. As a result the companies are burdened with much additional correspondence with reference to tax matters, as much of the information needed by the payee in filing the return can be acquired only directly from the company. To relieve themselves somewhat of this additional correspondence, many companies have considered it advisable to send each payee a complete statement of the information necessary for tax purposes at the beginning of the year.

State Inheritance Tax Requirements. In line with the recent general development of a more rigorous attitude on the part of the government regarding all types of taxation, several states have adopted the practice of requiring that insurance companies report to the tax authorities for inheritance tax purposes all claims under life insurance policies or supplementary contracts that are paid within the state. These requirements render it necessary that the company prepare additional notice for the taxing authorities at the time the claim is paid. Time is consumed in the actual preparation of such additional notice, and in those states where the correct legal address of the insured is subject to question, a serious difficulty may arise. In the latter case it is only reasonable that the deceased's last known permanent address should govern.

It is entirely proper that the state imposing such taxes receive proper notification of all claims paid, but the situation becomes complicated when the state requirements extend beyond a simple notice of the essential data pertaining to the claim. When, however, the company may not make payment until a release has been obtained from the proper tax department, the situation, in our opinion, often becomes unreasonable. While only a few states require such releases in connection with the death of the insured under a life insurance policy, many more require it in connection with settlements under supplementary contracts.[121] Often

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[121] See compilation of requirements at the present writing (1946) in Appendix C.2.

it is difficult for a foreign life insurance company to locate the proper state official from whom the release may be obtained, particularly when the estate is small.

In complicated cases the obtaining of this release may be delayed considerably. This will have the effect of delaying final settlement to the extent that in one respect the value of life insurance is lost completely. One of the leading advantages of investing in life insurance is the prompt payment available at death without the necessity of resorting to involved procedure such as probate or administration. Further complication in tax requirements, however, may defeat this end to the extent that the beneficiary will find it difficult to collect the proceeds without first employing an attorney to see that many involved requirements are met. The effect of such a situation upon the life insurance business is not good, and it is to be hoped that the future trends will be more reasonable.

Payments Involving Life Contingencies. The income payments under annuity policies or under the Life Income Option after the certain period has expired are due only upon condition that the annuitant or payee is living on the due date, and if the annuitant or payee is not living, the liability of the company under the contract is terminated altogether. The company has little occasion to correspond with the annuitant or payee other than to send remittances when due, and it would not necessarily be notified when the payee has died, since no benefit will accrue to anyone as a result. Before each payment is made, it is necessary that the company satisfy itself that the annuitant or payee is living, and the means by which this may be achieved brings up one of the most perplexing problems in life insurance administration.

There are four methods, none highly satisfactory, which may be employed toward this end: one method is to do nothing except to give adequate instruction to all collecting agencies; another is to compare all check endorsements with the signature of the annuitant or payee; a third method involves a regular periodical inspection of the annuitant or payee through either the company's own inspection facilities or through an outside agency to determine whether or not he is living; the fourth method is to send periodically to each annuitant or payee a form which under some pretext or other he is required to sign and return to the home office in order that the signatures may be compared. No matter which, if any, of these systems is employed, the payment check should include a special endorsement by which the endorser certifies that the annuitant is living and that the payment is due.

The do-nothing practice is justified upon the theory that a life insurance company need not concern itself too much over the danger of sending annuity checks to payees who are no longer living. No bank should honor a check payable to a party whom it knows to be deceased, particularly if the check is so drawn as to place the bank on guard in this respect. The danger of leaving the matter with the bank entirely lies in the fact that the company must rely upon practically every bank in the country to cooperate in prohibiting payment for which it is not liable, and it has no means of determining how faithfully the banks are performing this function. Furthermore, this rather casual system would not prevent a relative of the same name from continuing to receive payments, nor could it apply to cases where the annuity payments are made to third parties under an assignment or a power of attorney.

If the endorsement on the check is to be compared with the payee's signature, all such checks must be issued on a special form. This method would uncover immediately any case where a third party had endorsed the check, but this would not necessarily mean that the annuitant was not living. This method would not uncover a deliberate forgery, since the individual charged with the responsibility of inspecting the annuity check endorsements probably would not be a handwriting expert. The time required to inspect each signature to establish its validity would hardly justify the employment of a handwriting expert for this purpose. As it is, the expense of even a casual signature check is quite large.

An individual inspection of each annuitant or payee periodically is undoubtedly the most satisfactory method of establishing that he is or is not living. Unfortunately, the expense required to conduct such investigation hardly justifies the very few fraudulent cases which might be uncovered.[122]

The sending of a special form to the annuitant for his signature differs very little from comparing endorsements on the annuity check. The principal advantage of this system lies in the fact that it may adapt itself more readily to office procedure in bringing these two signatures together for comparison and that the annuity checks need not be segregated especially from the other periodical income items. The disadvantage of this system lies in the additional cost of mailing.

The difficulties in determining whether or not an annuitant or payee is living are increased considerably if the checks are sent directly to the bank for deposit to the account of the annuitant, or if the payment of income contingent upon the life of one person is made to a third party under an assignment or trust. In extreme cases it is conceivable that the recipient of the check may not be able to determine for a certainty whether or not the annuitant is living at the time the payment becomes due. The only solution in such cases is to require proof that the annuitant is living before each payment is made or, at least, at frequent intervals, or to obtain from the payee a guarantee that the company will be reimbursed for any payments made after the annuitant's death.[123] The most satisfactory proof that can be obtained easily is a special affidavit over the signature of the payee to the effect that the annuitant is living to the best of his knowledge.

This problem is one that almost defies solution. The various systems that we have outlined have not proven very successful in practice, and it is believed that their disadvantages probably far offset their advantages. Because it is only in rare cases that a third party would

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[122] An investigation of this kind undertaken at great expense in the author's own company brought to light no deaths that were not already accounted for.

[123] See Appendix B.6.

receive and continue to cash checks to the order of the annuitant after he had died, many authorities feel that the company need not concern itself too much with this problem. A few actuaries, on the other hand, suspect that payments depending upon life contingencies are continued long after the annuitant or payee has died, because of the unusually unfavorable experience with this class of business. No investigation, however, has brought to light specific instances illustrating this tendency to any great extent.

Changes and Withdrawals. Any item which alters or is supplementary to the regular periodical payment routine we shall refer to as a change for want of a better expression. Changes may be either contingent, automatic or elective. Contingent changes involve an independent occurrence, such as the death of the payee, which will be discussed later. Automatic changes involve a change in the periodical payments occurring upon a definite date and resulting either from the policyholder's election or the terms of the option elected. Elective changes involve the exercising of a privilege given the payee, such as the right of withdrawal, the right to elect another option or a change in the mailing instructions.

Among the automatic changes may be listed a change from one option to another on a stated date, such as a change from the Interest Option to the Life Income Option or the payment of the Family Income single sum payment under a Settlement Option, the termination of income altogether under the Fixed Period or Fixed Amount Options when the proceeds have been exhausted, a change in the amount of income under the Fixed Amount Option or under the Life Income Option or Continuous Instalment Policy at the end of the certain period, the payment of an additional single sum such as the payment on a specified date of a portion of the entire balance on deposit under the Interest or Fixed Amount Options or the payment of the single sum at the end of the income period under the Instalment Bond Option or Family Income Policy. The date and nature of all such changes must be shown clearly on the payment card in order to assure their initiation at the proper time, their smooth operation calls for an effective and dependable come-out system. An automatic change in the Supplementary Contract should not call for alteration of the contract itself, although there is no objection to an endorsement of the change thereon.

An automatic change may involve no change in the account but merely a change in the payee. This might occur through a provision in the election or it might occur when a minor payee comes of age. In the latter instance the payee is entitled to all payments falling due after he has come of age, nor is a court order or other evidence necessary in this connection.

The right of the payee to decide to change from one option to another depends upon the provisions of the Supplementary Contract and the practice of the company. The Settlement Option Rider does not provide for such elective changes, but provisions for such alterations may be incorporated in the Settlement Option Agreement.[124]

In the absence of such provision, it becomes a matter of company policy whether such changes will be permitted or not. Naturally, if the company will permit such change, the consent of the contingent payees must be obtained if they have an interest in the fund. As a general rule, if the payee has the right of withdrawal on his sole signature, the company is adequately protected if it permits him to withdraw the proceeds and redeposit them under another option provided it is not subject to any adverse selection against it in the transaction.

Another type of elective change is a voluntary withdrawal from the principal. One of the purposes of the Interest Option is to conserve the proceeds until needed for some future unforeseen emergency, when the proceeds may be withdrawn. A similar withdrawal privilege may be allowed under the Fixed Amount Option, and in some instances under the Fixed Period and Life Income Options the payee may be given the right to commute all future

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[124] See page 74.

instalments certain. Whether or not withdrawal or commutation is permitted is determined by the provisions of the settlement option, the provisions of the Supplementary Contract and company practice. If it is prohibited by the terms of the option nothing more need be said, but if it is permitted or if the option is silent, the Settlement Option Agreement or Supplementary Contract should elaborate further. Even though allowed by the terms of the option, it may be prohibited by the terms of the Supplementary Contract, in which case the provisions of the latter prevail. If the Supplementary Contract is silent and the option does not prohibit withdrawal or commutation, the question becomes a matter to be determined by company practice, but if under these conditions withdrawals are allowed, suitable releases should be obtained from all contingent payees.

The withdrawal procedure involves four essential steps: the calculation, the adjustment of the company records and accounts, the endorsement of the Supplementary Contract and the preparation of the check. The withdrawal payment must include accrued interest upon the amount withdrawn. A partial withdrawal under the Interest Option will reduce both the principal on deposit and the future interest income. Under the Fixed Amount Option it will shorten the income period. All essential records should be clearly marked accordingly. A request for a withdrawal must be accompanied by the Supplementary Contract, which must be submitted to the home office either to be reissued on the revised basis or endorsed to show the reduction in the principal. The issuance of the withdrawal check and its entry upon the company ledger account is a standard procedure.

Further types of changes are a change in the name of the payee or a change in address. While important, the operation in changing a payee's name warrants no further elaboration here. As regards a change of address the problem may be somewhat more complex. In the interest of good service, life insurance companies wish their remittances to be received promptly. Accordingly, all payees should be urged to notify the company promptly of any change in their address. While the mechanics of changing an address appear to be simple, the problem is complicated by the fact that the addressee may have both a supplementary contract and a policy in full force. Unless the company maintains a centralized address system, there is danger that the address may be changed on only one record with resulting disservice to the policyholder.

Death of the Payee. When a payee under a Supplementary Contract has died, the company should be notified promptly. Upon receipt of notice of death the first step is to determine the status of the account. The amount payable may be the balance on deposit with accrued interest to the date of death, the commuted value of all future instalments certain or the continuation of the income under the same or a new settlement option.

The second step is to determine that the payee is dead, although the problem here has nowhere near the same significance as do death claims under life insurance policies, for the insurer incurs no additional liability thereby. Even were the payee to falsify his death deliberately, he would merely deprive himself of the income in favor of the contingent payee. Furthermore, the company is in no way concerned as to the cause of death or the previous health history, so that the only proof of death required is an affidavit by the contingent payee or, preferably, a death certificate.

The third step is the determination of the proper payee. It is necessary first to determine the beneficiary or contingent payee entitled to payment and then to determine that he is living and is competent to receive payment. If the contingent payee is a minor or is mentally incompetent, settlement must be with his guardian, and if the contingent payee is the payee's estate, settlement must be with the duly qualified representative. If a large number of contingent payees are designated to receive the income, it may be necessary to pay the income at less frequent intervals or even to commute and pay in a single sum. If a class of contingent payees is designated, some or all of whom are not named in the Supplementary Contract, it is necessary to ascertain and identify all of the persons so designated before settlement may be effected. A suitable affidavit from someone acquainted with them all should suffice in this respect, as the Supplementary Contract should include a clause relieving the company from further liability should this information prove inaccurate.[125]

General Summary. In our discussion of life insurance income settlements, we have endeavored to give a comprehensive view of the subject by first outlining the provisions of the settlement options under which income settlements are made. This we followed with a discussion of the procedure by which the supplementary contract is created and of the settlement provisions that are incorporated in it. In closing we have endeavored to cover some of the administration problems arising in the maintenance of the income settlement accounts.

The forecast for the future of life insurance income settlements is so vast that a truly comprehensive analysis of the subject at present is both difficult and ill-advised. It has been our primary objective merely to bring to light some of the problems that are now confronting life insurance companies in the hope of promoting a still better understanding among life insurance agents and the general public.

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[125] See Article IV I of Appendix B.2.

APPENDICES

APPENDIX A

Supplementary Footnotes

1. (p. 2.) In this connection we quote from Guy B. Horton ("Some Legal Aspects of Life Insurance Trusts," 5) as follows:

"Insurance differs from the ordinary contract in that three people (or perhaps more) instead of two are interested. In other words, it is an agreement between A and B for the benefit of C. In a typical trust, likewise, three persons are interested—D gives E a fund to be held for the benefit of F. The trust is not a contract although often it results from a contract. The policy on the one hand because of the existence of the third party beneficiary and the trust on the other because of its inherent nature present complex aspects and are governed by more or less technical rules. If then the policy and the trust are brought together, the difficulties in each are multiplied by all the difficulties in the other, with a surprising and sometimes uncertain result. This then is the problem which both insurance companies and trust companies must consider."

2. (p. 3.) We quote again from Guy B. Horton ("Some Aspects of Life Insurance Trusts," 8-10) as follows:

"Of course, so far as the insurance as part of the trust res is concerned the trust is not completed when the trust instrument is executed, unless the trust instrument itself acts as an assignment or transfer as it usually does in funded trusts. The policy must be made payable to the trustee, but the trust arrangement if complete imposes on the insured the obligation to take the steps to place the insurance within the trust, by change of beneficiary, for instance. And on proper proceedings he can be compelled to take the necessary steps. Assuming the trust instrument contained no such provision, it is difficult to conceive how any court would consider it sufficient to transfer a revocable policy. The trustee would find he had the shell without the kernel. An irrevocable trust of revocable property would be an absurdity. The inconsistency would be very apparent in a trust consisting of one policy of insurance.

"The burden was imposed on himself by the insured's own act as trustor. It is not reasonable to hold that he can give a vested right and at the same time retain an unrestrained control in the same subject-matter. If he has reserved the right to amend, he may insert in the trust instrument a paragraph that the trustee may consent to any change of the beneficiary of the policy or he may insert a provision that the policy may be withdrawn or its beneficiary changed at his sole direction, and thereby the trustor will be restored to control of the policy. If he has reserved the right to revoke the trust, then after revocation there is no one to say him nay in obtaining a new beneficiary of the policy. If he has not made some such reservation, he cannot withdraw the insurance even though the policy says he can.

"Likewise, his future attitude toward borrowing on the policy is fixed by the provisions he has agreed to in creating the trust which includes the policy. If the trust instrument reserves to the insured the right to borrow on the policy, he may do so if the policy so allows. If the trust instrument does not reserve the borrowing power, he must go elsewhere for his loan, even though the policy says the insurance company will accommodate him."

3. (p. 3.) A situation recently was brought to the author's attention where a life insurance agent prevailed upon the policyholder to assign absolutely a substantial portion of his insurance to a trustee under a trust agreement which the agent had prepared and which was very poorly drawn. Under the agreement the trustee was authorized only to collect the death benefits and direct that the company hold them under a complicated settlement option arrangement for the insured's children, which, fortunately for the company, it was never requested to do.

Apparently, the sole purpose of the trust was to render the life insurance exempt from estate taxes. When the insured realized that the trust would not accomplish this objective because he continued to pay the premiums, he sought to have the trustee transfer ownership back to himself. The trust agreement, however, did not give the insured the right to revoke the trust, nor did it clearly give the trustee power to assign the insurance policies. As a result the company was forced to advise the insured to bring suit to have the rights of the trustee clarified. This placed the company in an embarrassing position, as the original transaction was suggested by its agent, who did not obtain proper legal advice.

4. (p. 4.) We quote from Walter J. Wheeler and Thomas Lea Todd ("Safeguarding Life Insurance Proceeds," pp. 68-9) as follows:

"For purposes of illustration an underwriter may desire to work out a model settlement plan against which he can check the desires of a particular policyholder, but he should not make any stereotyped plan the basis of his recommendations in a given case. He will learn from experience that no two policyholders have exactly the same needs and no two settlement arrangements are exactly alike. This means that there is no special short-cut method or rule of thumb for him to use. Every case will demand that he possess a thoroughgoing knowledge of his business and intelligently apply it to the facts in the case.

"The underwriter must have an intimate knowledge of a wide range of problems and circumstances. He needs this to give him the proper perspective. It is probably accurate to say that the underwriter who is best informed about the needs of the most varied group of policyholders is best qualified to make recommendations to satisfy the needs of any particular policyholder."

5. (p. 34.) The following paragraph being Article Ten of the Illustrative Pension Trust Agreement published by the Insurance Research and Review Service ("A Study of Pension and Other Employees Trusts," pp. 36-7) or some similar provision should be in every pension trust agreement:

"No insurance company which may issue any policies for the purpose of this agreement shall be required to take or permit any action contrary to the provisions of said policies, nor shall such insurance company be deemed to be a party to this Agreement for any purpose; nor shall it be responsible for the validity of this Agreement. No such insurance company shall be required to look into the terms of this Agreement or question any action of the Trustee hereunder, nor be responsible to see that any action of the Trustee is authorized by the terms of this Agreement. Any such issuing insurance company shall be fully discharged from any and all liability for any amount paid to the Trustee or paid in accordance with the direction of the Trustee, as the case may be, or for any change made or action taken by such insurance company upon such direction; and no such insurance company shall be obliged to see to the distribution or further application of any monies so paid by it. The certificate of the Trustee under its corporate seal, signed by its President, Vice-President, or Secretary or other authorized representative thereof, may be received by any insurance company as conclusive evidence of any of the matters mentioned in this Agreement, and any insurance company shall be fully protected in taking or permitting any action on the faith thereof and shall incur no liability or responsibility for so doing."

6. (p. 38.) Under Section 22 (b) of the Internal Revenue Code, if the amount were payable in a lump sum upon maturity, the difference between the aggregate premiums paid and the amount received would be includible in gross income. If, however, the insured prior to maturity of the policy elected to have the endowment proceeds payable in instalments this would be considered under Section 22(b) (2) similar to an annuity and the insured would have to include in gross income only 3% of the aggregate premiums paid until "the aggregate amount excluded from gross income . . . equals the aggregate premiums or consideration paid."

To the same effect as Section 22(b) (2) is Reg. Section 29.22(b) (2)-2. This section and regulation is further clarified by General Counsel's Memorandum Opinion No. 21666, which states in effect that an endowment policy payable in instalments constitutes annuity payments and is taxable in the same manner as set forth in Reg. Section 19.22(b) (2)-2.

There has been some doubt as to whether the tax savings would be effective if the insured elected after maturity to have the proceeds payable in instalments. The general consensus of opinion is that it would be much safer from a tax savings standpoint to have the settlement option elected prior to maturity. If the insured waited until maturity to elect the settlement option the tax authorities might consider that under the "constructive receipt" theory the insured had actually received the money and that he had taken this money and placed it under the instalment option, if the "constructive receipt" theory would apply, then the gain in the year of maturity would be includable in gross income. If, however, the insured elects prior to maturity to have the proceeds payable in instalments, then he is considered as receiving an annuity and is taxable only to the extent of 3% of the consideration paid until he has recovered by exclusions from gross income the amount paid as premiums.

7. (p. 39.) It is argued that the company should allow interest because it has possession of the money throughout the period of the transaction. While this may be technically true in that the beneficiary never receives the funds, the company is not in a position to pay interest, as it is unable to invest these particular funds. As a matter of sound practice it should maintain in bank sufficient funds to cover the pending liability, and if its check has been issued, it must maintain in bank sufficient funds to cover this item should it be presented for payment. Funds so placed do not earn interest for the insurer.

8. (p. 40.) The term *agreement* is considered as legally preferable because the spendthrift or restraint on alienation laws of most states specify that the income shall be exempt from the claims of the beneficiary's creditors only if it is so provided by agreement.

9. (p. 41.) This latter method is of advantage in that the requirement that the policy be endorsed is eliminated. The policyholder and the agent are relieved of the necessity of securing the policy and submitting it to the home office for endorsement; the home office is relieved of the additional expense of handling the policy, placing the endorsement thereon, and mailing it back to the agent when endorsed; and the policy itself retains a neater appearance, since, although there may be several successive changes of beneficiary, it does not become cluttered up with numerous endorsements. The requirement that any change of beneficiary be endorsed upon the policy is of advantage in that it at all times will contain a complete history of all beneficiary designations and in that a change of beneficiary cannot be effected if the policy is in the possession of a third party who has an interest therein, of which the company is not aware, and who refuses to relinquish the policy for endorsement of the proposed change. The determination of the procedure that is preferable depends upon whether the insurer feels that the legal difficulties or the office difficulties are of more consequence; in practice those companies which do not require endorsement of changes of beneficiary upon the policy have not suffered thereby.

10. (p. 42.) The following form of endorsement should suffice:

"This policy having matured by the death of the insured, the net proceeds thereof are now being paid in accordance with the provisions contained in said policy or in a subsequent amendment thereto."

11. (p. 45.) The author once experienced a situation in which the wife of the deceased in her capacity as executor of his estate elected to leave the proceeds on deposit, and had not withdrawn them at her death some fifteen years later. Upon her death there was no end of legal complications in having a successor executor appointed and making a final distribution, as many of the insured's heirs had since died.

If proceeds are to be held on deposit for an executor or administrator, the period of retention should be limited to not more than three years.

12. (p. 46.) It is felt that a life insurance company should not assume the burden of investing trust company funds, since a trust company is adequately equipped to assume such responsibilities. Where the trustee is an individual, however, it is assumed that he is little better qualified to invest funds than the average beneficiary, so that it seems reasonable to permit such a trustee to exercise the settlement option privilege.

13. (p. 53.) The situation becomes particularly complicated if there is a change of payee upon a specified date, as when the proceeds are held for the wife with the stipulation that as the children respectively attain a given age a portion of the fund is to be paid to them. The insured may survive the given age; the wife may die prior thereto; or one of the children might not be living. Guy B. Horton illustrates in the Appendix of his text "Making the Best Use of Your Insurance," how a similar apparently simple request is in truth so complicated as to require some twenty pages to state all the contingencies.

14. (p. 55.) There are two methods by which an unequal division of the funds may be effected: one is to provide that each beneficiary designated shall receive a stipulated percent or fraction of the proceeds, and the other is to stipulate that one beneficiary shall receive a designated amount, provided the proceeds are adequate, and that any balance remaining shall be divided among the remaining beneficiaries as specified. The first method has the advantage of guaranteeing to each beneficiary a proportionate share of the proceeds, while the second is of advantage if it is of importance that the amount payable to one of the beneficiaries be determined exactly. In no case should the amount to be paid to each of the beneficiaries be designated exactly, since the exact amount of the policy proceeds cannot be determined in advance, with the result that it may require litigation to clarify the interest of each beneficiary.

15. (p. 59.) Horton ("Power of an Insured to Control the Proceeds of His Policies," 51), states the law against perpetuities as follows: "There is an old and very well recognized rule stating the limits within which legal and

equitable interests must vest if the disposition thereof is to be valid, or, if looked at from another angle, the time within which future interests can be created. This is called the Rule against Perpetuities, or the Rule against Remoteness, and is defined as follows:

"No interest is good unless it must vest, if at all, not later than 21 years after some life in being at the creation of the interest."

"This rule, or the limits which it creates, applies to personalty as well as realty and governs both legal and equitable interests."

On page 71 are stated the laws existing in some of the states which do not follow the general rule.

The extent to which this law applies to insurance proceeds has been in dispute. In this connection we quote from Louis Danziger, A. L. I. C. IV, 467: "At our meeting in June, 1919, I read a paper on The Rule Against Perpetuities as it Affects Life Insurance. That I therein correctly stated the rule, and that the law was there accurately outlined, I remain convinced, but after much study and with a fuller and better knowledge of the subject, I am not now satisfied with the conclusion I then arrived at, namely, that the rule applies to life insurance policies."

The question has been further clarified by the decision rendered in Holmes v. John Hancock Mutual Life Insurance Co. [41 N. E. (2) 909], decided by the New York Court of Appeals on April 23, 1942. We quote from the opinion announced by Chief Justice Lehman with all the other judges concurring as follows:

"Each of the policies contained provisions permitting the insured to nominate and change the beneficiary to whom the proceeds of the policies should be paid and also offering to the insured 'optional methods of settlement.' Before his death the insured nominated his wife, the defendant Marie F. Holmes, and his nephews, the defendants William R. Holmes and Morgan Dwight Holmes, as beneficiaries under each of said policies, and directed that the proceeds of the policies be left on deposit with the Company, and that the interest be paid quarterly to his wife during her lifetime and after her death to his nephews 'until the elder or survivor of said nephews attains the age of thirty-five,' and that thereafter the principal be paid to the nephews or to the survivor. The plaintiff challenges the validity of these directions on the ground that they constitute an unlawful suspension of the power of alienation.

"We may assume that if the proceeds of the policies constituted a trust fund, these directions would be void under the provisions of section 11 of the Personal Property Law (Cons. Laws, ch. 41). The insurance company does not, however, hold the proceeds of the policy as a trust fund. By the terms of the policy it has contracted to pay stipulated amounts, at stipulated times and in stipulated manner. 'The obligation of the insurance company constitutes a debt from the company to . . . the beneficiary, under the policy.' The stipulated payments are not income on personal property. They constitute deferred payments which the company agreed to make to the beneficiary . . . (Crossman Co. v. Rauch, 263 N. Y. 264, 273). The provisions of section 11 of the Personal Property Law have no application to such an obligation."

16. (p. 66.) "Two opposite theories of the extent of possible restraints on the alienation of property exist. The English doctrine, based on the theory that all estates possess the quality of alienability and liability for debts, denies the validity of limitations thereon which, it declares, do violence to the fundamental incidents of property ownership. The American doctrine, on the other hand, is that a donor may stipulate the terms on which his gift may be received and lawfully provide that the interests of the donee shall not be assignable or be subject to the claims of the donee's creditors.

"The latter rule is enforced in the majority but not all of the states, and where enforced is held in somewhat different degrees. Furthermore, the English doctrine concedes that a donor may pass to the donee an estate which will terminate on the donee's bankruptcy or attempt to convey.

"Restraints on alienation have been sought along two general lines:

"1. Forfeiture for alienation.

"No attempt is made to attach any character of inalienability to the estate but the estate is given either on condition that it shall not be alienated or to be held until it is alienated; that is, it is subject either to a condition, for breach of which the grantor may enter, or to a limitation which on alienation puts an end to it without entering. The owner of the estate is not compelled to keep it against his will; he may assign as he pleases; but if he does, the estate is forfeited or liable to forfeiture.

"The sufficiency of this method is generally conceded, even in England.

"2. Declared inalienability.

"The estate or interest may be declared to be inalienable. If this declaration is legally valid the holder of the estate, like Sinbad the sailor, cannot rid himself of the burden. Any attempted assignment is inoperative and the estate remains with him."—Horton, "Power of an Insured to Control the Proceeds of his Policies," 57-8.

17. (p. 66.) It is the established rule that, in the absence of any policy provision and law specifically providing otherwise, any dividends left with the company to accumulate at interest are payable to the insured's estate rather than to the beneficiary. This rule was upheld in Phoenix v. Klaw, 1 N. Y. Supp. (2) 391, in which the court referred to 55 A, now Section 166 of the New York Insurance Code. This case subsequently was taken to the Appellate Court, and the opinion is found in 5 N. Y. (2) page 170.

The lower court held that in view of Section 55 A of the New York Insurance Code the beneficiary was entitled to the proceeds and avails against the creditors and representative of the insured's estate. The Appellate Court, however, reversed the lower court and took the position that Section 55 A did not apply to policies issued prior to March 31, 1927, the effective date of the law. Both courts specifically stated that if it were not for the statute or the provision in the policy providing for payment to the beneficiary, the dividends should be paid to the insured's executors or administrators.

To correct this situation under policies which do not include a specific provision that the dividend deposits will be paid with the policy proceeds, it is believed that it is sufficient to include in the Settlement Option Agreement a provision to the effect that the net sum covered thereby includes dividend deposits. This is covered by Article V, Section F in Appendix B.7a.

18. (p. 69.) Such was the decision of the Court in Union & New Haven Trust Co. v. Koletsky, 167 Atl. 803. Here the policyholder executed a settlement option agreement which the insurer accepted and which provided for retention of the proceeds under the Interest Option for the benefit of the policyholder's daughter. It provided, however, that any payments of interest due the daughter would be made to the Union & New Haven Trust Co. as trustee. The agreement did not indicate the nature of the trust under which the interest payments would be so made. The Court found as follows:

"The conclusion to which we come is that Koletsky intended either that the trustee should exercise functions which he has not declared, or that it was merely to receive the interest from time to time and pay it over to the daughter. If the first is the true situation, the attempted trust, as we have indicated, cannot be enforced because of uncertainty as to its nature and the rights and duties of the trustee; and if the second presents the true situation, the trust is a dry or simple one, which cannot be used to withhold from the daughter the interest payments due her. . . . There being no effective trust created by the terms of the certificates, the future payments should be made by the insurer to the guardian of the estate of the daughter during her minority and the plaintiff should turn over to the guardian such sums as it has already received from the insurance company."

In this same decision the insurer was severely criticized. The Court said, "The record shows that it (the company) prepared the certificates in question and, though not legally bound to do so, in fairness to Koletsky, its insured, it should not have prepared and accepted certificates so faulty as these were."

As a result of this "faulty certificate" the insurance money was not administered in the manner originally intended by the policyholder and the insurer was subjected to the cost and annoyance of litigation and was harshly rebuked. The significant thing about this decision, however, is that, although it was criticized, the company was not held to be "legally bound" to investigate the validity of a change of beneficiary. Thus the insurer is not forbidden to accept certain types of beneficiary designations involving obscure legal issues. The principal risk it runs in so doing is the annoyance of possible litigation and the failure to render its client first-class service.

19. (p. 78.) The provisions of this agreement are subject to the condition that in the event written notice of the remarriage of Insured's wife is furnished to the Company at its Home Office and any of the other personal beneficiaries herein named are then living, payment to Insured's wife as provided herein shall cease and payment thereafter shall be made in the same manner as is provided herein upon Insured's wife's death.

20. (p. 80.) Upon receipt of written notice from Primary Beneficiary that she is entitled to Social Security payments, the income payable to Primary Beneficiary as provided in Art. II shall be reduced by the amount of the monthly Social Security payments to which she is entitled. Notice of any increase or decrease in said Social Security payments shall be furnished from time to time by Primary Beneficiary, and the Company is authorized to act on her sole signature, nor is it obligated to act except upon receipt of such notice at its Home Office.

21. (p. 84.) Two lines of authority tend to say that the remaining proceeds must be paid to the estate of the primary beneficiary and not to the named contingent payees. The first of these lines of authority developed over the question as to who was entitled to bank deposits made by a decedent in the name of another person, but with the right reserved in the decedent to use the bank deposit during his lifetime. In the early case of Pope v. Burlington Savings Bank, 56 Vermont, 284 (1883), the Vermont Court treated the original transaction as an attempted gift. The Court held that the gift was never completed and therefore the so-called contingent payee never acquired any rights at all. Apparently the Court did not consider the possibility that the bank had entered into a contract with the decedent to pay the remaining funds to the contingent payee in the event of decedent's death. Thereafter, several courts have followed the Vermont Court in treating such questions as questions of Gift alone. See Hicks v. Meadows (Alabama), 69 So., 432 (1915); Ferry v. Bryant (Tennessee), 93 S. W. (2d) 344 (1935); Geisel v. Burg (Michigan), 26 N. W. 904 (1937). In these cases the possible element of a contract between the decedent and the bank, or other debtor, was not seriously considered.

The second line of authority recognizes the contract but refuses to enforce the contract on the ground that it is an attempt to make a testamentary disposition in a manner not prescribed and not permitted by law. This line of authority is supported by many cases but is best exemplified by the case of McCarthy v. Pieret, 24 N. E. (2d), 102 (1939), which was decided by the New York Court of Appeals. This case involved an attempt by a mortgagee to make the proceeds of a mortgage payable to contingent payees in the event of the mortgagee's death. The contingent payees, upon the death of the mortgagee, argued first that the original transaction was a gift by the mortgagee and should be sustained. The Appellate Division of the Supreme Court had held that there was a valid gift. On the basis of the first line of authority discussed above, the Court of Appeals reversed this decision and said that the gift was never completed. The contingent payees then argued that the original transaction amounted to a contract whereby the mortgagor agreed to pay his obligation to the contingent payees in the event of the mortgagee's death. To this the Court of Appeals responded that the contract could not be upheld because it was an attempt to make a testamentary disposition in a manner not permitted by law.

On the basis of this case and on the case of Decker v. Fowler (which will be discussed below), the Supreme Court of New York promulgated a similar decision on June 23, 1942. This is the decision in Deyo v. Adams, 36 N. Y. Supp. (2d) 734. This decision involved a United States Savings Bond made payable to William J. Deyo and upon his death to May Adams, his sister. William J. Deyo died leaving his wife, Ann Deyo, as principal heir and as executrix of his estate. As executrix, Mrs. Deyo brought suit against the defendant, May Adams, to prevent the defendant from collecting the proceeds of the bond. The Court held that the Complaint, which had stated the facts given above, stated sufficient facts to constitute a cause of action.

The Supreme Court of Washington has recently held that the designation of a contingent payee of a United States bond is of no effect and that the bond goes to the estate of the original owner at the time of his death. This is the case of Decker v. Fowler, 92 Pac. (2d) 254 (1939). The Court based its decision on the old authority of uncompleted gifts. In the State of Washington, it is my opinion that argument still is possible on the basis of contract. In the states of Alabama, Tennessee and Michigan, the question can hardly be said to be settled on the basis of the cases cited above. These cases involve bank deposits and apparently no consideration of a contract between the creditor and the primary payee and the contingent payees was deemed of importance. In fact, in the Michigan case it appears doubtful that any contract at all could be made out on the part of the bank other than to pay the money to the original payee or his estate.

In addition, there is a respectable line of authority which holds that a man may make a contract with another man whereby such other man will pay to the original party or to certain contingent payees in the event of the first man's death. The Indiana Court in Baker v. Williams, 34 Indiana, 547, upheld the right of the contingent payees in an early case decided in 1870. In 1929 the United States Court of Claims, in Warren v. United States, 68 Court of Claims, 634, upheld the right of contingent payees under United States bond. The United States Supreme Court denied certiorari in this case (281 U. S. 739). The opinion in a Lower Court of Ohio has upheld the right of the contingent payees in a United States bond.

Mr. Orville F. Grahame in his splendid paper "Disposition under Supplementary Contracts" [A. L. C., L. S. (1936) 93-143], cites among others the case of Stevenson v. Earl [65 N. J. E. 721, 55 A. 1091 (1903)], in which a depositor in the savings fund of the Pennsylvania Railway Company at the time of opening his account therein had directed the company to pay his wife in the event of his death all deposits then standing to his account. There was a right of withdrawal, after ten days' notice. The Court said:

> "Such a gift, it seems to us, is purely testamentary in its character. If it is not, then it is a perfectly easy thing for a person to retain the absolute control and dominion over his moneys and personal securities during his life and transfer that dominion to another at his death, with total disregard of the requirements contained in the statute of wills, by the simple device of depositing such moneys and securities, under an agreement with the depositary that he shall have the right to use them or deal with them as he pleases during his life, and that at his death so much of them as may remain shall be delivered to such person as is named in the agreement, who shall then become the owner thereof, and then delivering the agreement to the beneficiary with a statement of the same purport as that made by the deceased to his wife when he gave

the passbook to her. To hold that such a method of disposing of property by the owner at his death is valid, would be to practically repeal the statute of wills in its operation upon personal property, so far as its mandatory provisions are concerned."

22. (p. 36.) The Revenue Act of 1942 does not provide any exemptions for life insurance upon the life of the decedent, but does provide for a general exemption of $60,000.00. The conditions under which insurance upon the life of the decedent are and are not subject to federal estate tax are clearly set forth on pages 110 to 116 of "Life Insurance and the Federal Estate Tax Laws—1946 Edition" published by the Diamond Life Bulletin, and the "Diamond Life Bulletin Finder System—The Federal Estate Tax," pages 11 to 16 (12th Printing). We quote in part as follows:

A. All proceeds payable to the estate or the executor (except that which by State law inures to wife and/or child, which is exempt to same extent as if beneficiary had been named in policy) or payable for the benefit of the estate (including those received by creditor in liquidation of insured's debt where the policy had been procured or assigned as collateral security for a loan but not the balance payable to a named beneficiary other than the estate unless it would otherwise be included), are included in the gross estate.

B. Life Insurance not otherwise includable in the gross estate will, if transferred in contemplation of death or as a gift intended to take effect in possession or enjoyment at or after death, be includable (in proportion to premiums paid by insured).

If the purpose of an assignment is to avoid Estate Tax, it is considered as made "in contemplation of death." However, if the desire to save Estate Taxes is incidental to another and dominating reason associated with life, it may not be sufficient to make the gift includable in the estate as made "in contemplation of death."

If incidents of ownership possessed by an insured are gratuitously transferred but a reversionary interest is reserved, proceeds are includable even though insured paid no premiums.

C. If insured paid any or all of the premiums before and/or after January 10, 1941, directly or indirectly, and possessed at his death any incident of ownership in the policy (except a reversionary interest) exercisable either alone or in conjunction with any other person, the entire amount of the proceeds is includable in his estate.

D. If, however, insured paid premiums, directly or indirectly, prior to and/or after January 10, 1941, but after that date divested himself of all incidents of ownership (except a reversionary interest), the Insurance proceeds are includable in his estate in proportion to the total premiums he paid (even though the policy was fully paid-up prior to January 10, 1941).

E. If insured paid all of the premiums before and/or after January 10, 1941, directly or indirectly, but disposed of all incidents of ownership prior to January 10, 1941 (except a reversionary interest), the Insurance proceeds are includable in his estate in the proportion that the premiums paid by the insured after January 10, 1941, bear to the total amount of premiums paid.

F. If insured paid no premiums, either directly or indirectly, after January 10, 1941, and disposed of all incidents of ownership prior to that date, the Insurance proceeds are not includable in his estate.

G. If insured has paid all premiums, either directly or indirectly, but has at no time had any incident of ownership in the policy (except a reversionary interest) the Insurance proceeds are includable in his estate in the proportion that the premiums paid after January 10, 1941, bear to the total premiums paid.

H. If insured has paid a portion of the premiums directly or indirectly but never had any incident of ownership in the policy (except a reversionary interest), the Insurance proceeds are includable in his estate in the proportion that the premiums paid by insured after January 10, 1941, bear to the total premiums paid by him and all other persons.

I. Even if insured paid none of the premiums and all were paid by someone other than the insured, the proceeds are includable in full if the insured possessed at his death any incident of ownership in the policy, exercisable either alone or in conjunction with any other person (except a reversionary interest).

The right of the employee to name or change the beneficiary of a Group Insurance policy on which the premiums are paid by his employer may be regarded as an incident of ownership, thus rendering the Insurance taxable.

J. Sale. If the insured transferred a policy for adequate, valuable consideration (so that the transfer was not a gift) and did not retain any incident of ownership in the policy, the proceeds are not includable in his estate, even though prior to the transfer he paid the premiums.

K. Incidents of Ownership. Incidents of ownership in the policy include, for example, the right of the insured or his estate to its economic benefits, the power to change the beneficiary, to surrender or cancel the policy, to assign it, to revoke an assignment, to pledge it for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc., but not a reversionary interest except in the determination of ratio of premiums paid by decedent to total premiums paid. The term "incidents of ownership" includes those possessed by the decedent as manager of the community where the insurance policy is property held as community property by the decedent and spouse.

The Tax Court, following several Board of Tax Appeals decisions in earlier cases, has held that a reservation of the right to receive any dividends is not an incident of ownership.

A retained right to cancel or change the interests of contingent beneficiaries without their consent is an incident of ownership.

23. (p. 87.) We quote from Guy B. Horton ("Making the Best Use of Your Insurance," 127-8) as follows:

"However, assuming that it works and is legal, some interesting results appear in practice. Each controller in turn has full power over the policies as long as he lives with right of disposition, e. g., to borrow, surrender, etc. Suppose A, the owner, transfers all his rights to X. This does nothing less, nor more, than substitute X for A. X can deal with the insurance—even surrender it—under the same terms and conditions that A could if he had retained control, but since the acts of A must be within his life, so the Acts of X must be within the same life, i. e., A's. For instance, suppose after A's death X desires to exercise A's right to surrender. The necessity that every act by X be accompanied by proof that A is alive interferes with the convenience of the scheme, to say the least."

24. (p. 88.) Many authorities hold that when the interest of the beneficiary may be divested by the policyholder it must be divested by the method set forth in the policy. The assignment procedure does not carry out this method, and so does not remove the beneficiary. Unless the assignee subsequently removes the beneficiary by the prescribed method, the beneficiary may claim the entire policy proceeds at the insured's death.

Other authorities hold that the policy provisions by which the beneficiary may be changed are included for the protection of the insurer alone and not for the protection of the beneficiary. Since the interest of the beneficiary is that of only a mere expectancy which may be divested at any time, the assignment takes precedence over the beneficiary designation and is, in effect, tantamount to a change of beneficiary.

Because of the conflicting rulings in different jurisdictions on this question, with the resulting confusion as to the rights of the beneficiary under an assignment, it is suggested that some procedure be followed by which the rights of the assignee will be clarified and protected. This may be achieved through the inclusion of a specific policy provision giving the insured the right on her sole signature to assign the interest of the beneficiary. In the absence of such a provision in the policy two alternative methods have been suggested. One method is to have the beneficiary join with the policyholder in executing the assignment, and the other is to have the policyholder first change the beneficiary to his estate.

25. (p 92.) A particularly complicated situation of this type that is frequently encountered is where the company is requested to hold the proceeds on deposit and pay periodical instalments of a fixed amount to which is added the interest which is due on the principal. This plan necessitates an additional interest calculation with each instalment that is paid, as the amount of the principal is constantly reducing.

26. (p. 105.) Commissioner v. Winslow, 39 Board of Tax Appeals 373; United States Circuit Court of Appeals, First Circuit, 113 Fed. (2d) 418.

Commissioner v. Bartlett, United States Circuit Court of Appeals, Second Circuit, 113 Fed. (2d) 766.

Commissioner v. Buck, 41 B. T. A. 99, United States Circuit Court of Appeals, Second Circuit, 120 Fed. (2d) 775.

Allis v. LaBudde et al., Executors, Circuit Court of Appeals, Seventh Circuit, June 15, 1942, 128 Fed. (2d) 838, reversing United States District Court, Eastern District of Wisconsin.

Louise E. Kaufman v. United States, United States Circuit Court of Appeals, Fourth Circuit, November 12, 1942, 131 Fed. (2d) 854, reversing United States District Court, Eastern District of Virginia.

Lilienthal, Tax Court Memo., February 6, 1943.

Heilbroner v. Commissioner, Circuit Court of Appeals, Second Circuit, 100 Fed. (2d) 379.

Jones v. Maloney, Collector, Oregon, May 11, 1942; Sands, 1943, Oklahoma; Leatherman v. United States, Miss., Northern District, Delta Division, June 12, 1942; Chappellet v. Rogan, Collector, California, Southern District, Central Division, October 27, 1942.

Whitmer, B. T. A. Memo., Docket No. 104659, October 20, 1941; Thatcher v. Commissioner, 46 B. T. A. 869; Lilienthal, Tax Court Memo., Feb. 6, 1943.

APPENDIX B

Illustrative Forms

I. The Settlement Option Provision Incorporated in the Policy

(with all tables omitted)

1. **Settlement Options.** The owner of this policy may, by written notice to the Company at its Home Office, in form acceptable to the Company, which will be furnished on request, elect to have the proceeds payable under this policy upon the death of the insured, or upon its maturity as an endowment or upon surrender for its cash value, paid in accordance with any one of the following options in lieu of in a single sum; and the beneficiary, after the death of the insured, no prior election having been made, may elect to receive the proceeds in accordance with any one of the following options when the said proceeds are payable in a single sum to the said beneficiary. In order for an election to be acceptable to the Company the payee must be a natural person in his or her own right.

2. *Option 1—Certain Instalments.* The proceeds may be paid in equal annual or monthly instalments, without right of the payee to commute, for any specified number of years (not exceeding twenty-five), the first instalment being payable immediately, in accordance with the attached table for each thousand dollars of said proceeds. Instalments, after the first, will be increased from profits as annually determined and apportioned by the Company.

3. *Option 2—Continuous Instalments.* The proceeds may be paid in equal annual or monthly instalments, without right of the payee to commute, the first instalment being payable immediately, for a period of ten (10), fifteen (15) or twenty (20) years certain, and for as long thereafter as the payee shall survive, in accordance with the attached table for each thousand dollars of said proceeds.

Instalments, after the first, will be increased from profits as annually determined and apportioned by the Company, but not beyond the period of certain instalments. Before commencing payments the Company may require satisfactory proof of the date of birth of the payee and may require due proof that the payee is living before the payment of each or any instalment hereunder is made.

4. *Option 3—Retained at Interest.* The proceeds may be left with the Company at two per cent interest payable annually during the lifetime of the payee. If desired, interest will be paid in semi-annual, quarterly or monthly parts of equivalent value, beginning six months, three months or one month, respectively, after the date on which the proceeds become payable. Interest payments will be increased from profits as annually determined and apportioned by the Company.

5. *Option 4—Fixed Income.* The proceeds may be paid in equal annual, semi-annual, quarterly or monthly instalments, the first instalment being payable immediately, each of such amount as may be elected, provided that the total amount paid in a year shall be not less than six per cent of the original proceeds, and continuing until the said proceeds and interest are exhausted, provided that the final instalment shall include any balance of less than one instalment. On each anniversary of the first instalment, interest on the unpaid balance will be added thereto at two per cent per annum, which will be increased from profits as annually determined and apportioned by the Company.

6. *Withdrawal Privilege.* Unless otherwise specified in the election of Option 3 or 4 the entire sum held by the Company together with any accrued interest may be withdrawn at any time. Payment may be deferred by the Company ninety days from the request for withdrawal.

7. *Semi-Annual and Quarterly Instalments.* If desired, semi-annual or quarterly instalments will be paid under Options 1 and 2. The semi-annual and quarterly instalments under Option 1 will be equal to and under Option 2 not less

than .5037 and .2528 times the annual instalments, respectively.

8. *Minimum Payments.* If semi-annual, quarterly or monthly instalments or interest payments are requested and such payments are less than Ten Dollars ($10.00), the Company reserves the right to make payments at less frequent intervals, and if under any option elected the amount of annual instalment or interest payment would be less than Ten Dollars ($10.00), the Company reserves the right to pay the amount due in a single sum to the payee then entitled to receive instalments or interest under the terms of the election.

9. *Guaranteed Rate of Interest.* The instalments provided under Options 1 and 2 are based on a guaranteed interest rate of two per cent compounded annually. Upon the death of the payee last entitled to receive instalments, any remaining unpaid certain instalments shall be commuted on the basis of two per cent interest compounded annually and paid in one sum to the executors or administrators of the said payee, unless otherwise provided in the election.

2. The Election of Settlement Option Agreement

(All items in small type indicates individual entries, the larger type being the matter that is printed in the form)

Policy: 1 234 567 Insured: Roger W. Clark

The undersigned hereby revokes any previous designation of beneficiary or method of settlement under the above numbered policy or policies and directs that settlement thereunder upon Insured's death be made as follows:

ARTICLE I—DESIGNATION OF BENEFICIARY

	NAME	RELATION TO INSURED	DATE OF BIRTH
A. Primary Beneficiary shall be	Laura L. Clark	Wife	
B. Contingent Beneficiary shall be	Laura Anne Clark Christine Evans Clark And any other children of Insured *per stirpes* (See Article IV-E)	Children	3/8/40 4/9/43
C. Second Contingent Beneficiary shall be	None		
D. Final Beneficiary shall be	the executors or administrators of the survivor of Insured, Primary Beneficiary and Contingent Beneficiary.		

ARTICLE II—METHOD OF SETTLEMENT

A. Settlement with Primary Beneficiary. Upon Insured's death the net sum payable under the above numbered policy or policies treated as one sum, shall be paid to the Primary Beneficiary in the following manner:

Retained under the Interest Option (Opt. #3) with the right of withdrawal at any time, and with the interest payable in equal monthly instalments.

B. Settlement with Contingent Beneficiary. Upon Primary Beneficiary's death while entitled to receive under any option other than the Interest or Fixed Income Option, any instalments certain remaining unpaid shall be continued to Contingent Beneficiary, except that their commuted value shall be paid if it is specifically stated below that settlement with Contingent Beneficiary shall be in a single sum. Upon Primary Beneficiary's death while entitled to receive under the Interest or Fixed Income Option, or upon Insured's death should Primary Beneficiary predecease Insured, the amount then due shall be paid to Contingent Beneficiary in the following manner:

Retained under the Interest Option (Opt. #3) without the right of withdrawal, and with the interest payable in equal monthly instalments until her eighteenth birthday, when or upon first becoming entitled to payment, if thereafter, the amount then due shall be paid in monthly certain instalments for four years, without the right of commutation, in accordance with Option #1.

C. Final Settlement. Upon the death of the survivor of Insured, Primary Beneficiary and Contingent Beneficiary, any amount then due shall be paid in a single sum to Second Contingent Beneficiary, otherwise to Final Beneficiary.

ARTICLE III—SPECIAL PROVISIONS

A. Spendthrift Clause. Insofar as is permitted by the law of the state having jurisdiction, the benefits accruing hereunder to the beneficiaries named herein, other than Insured, shall not be subject to commutation nor anticipation unless expressly provided for herein, and shall not be transferable, nor subject to encumbrance, the claims of creditors nor to legal process.

B. Reservation of Rights. No beneficiary shall have any vested right or interest solely by reason of being designated herein. The right to revoke this agreement, change the beneficiary, to exercise every right and receive every benefit reserved to Insured or the owner, including the right of assignment, to agree with the Company to any change or amendment of the policy without the consent or removal of any beneficiary is reserved, notwithstanding the execution of this agreement.

C. **Right to Elect Another Option.** At any time within six months following Insured's death, Primary Beneficiary may revoke this agreement in whole or in part by withdrawing the sum retained, or a portion thereof, and electing that the sum withdrawn be paid in accordance with any other option in the policy just as though no prior election had been made.

D. **Common Disaster.** Because of the prevalence of common disasters, in no case shall payment be made to any of the persons designated in Article I until thirty days after Insured's death, and in the event of the death of a person during the thirty-day period immediately following Insured's death, payment shall be made in the same manner provided herein had said person predeceased Insured.

E. **Clean-up Fund.** One Thousand ($1,000.00) Dollars of the net sum payable, or the entire said net sum, if less than that amount, shall be paid immediately upon Insured's death to Primary Beneficiary, otherwise to Contingent Beneficiary, otherwise to Insured's executors or administrators, and any reference elsewhere herein to "the net sum payable" shall pertain only to any balance remaining after such payment has been made.

ARTICLE IV—MISCELLANEOUS

A. **General.**

(1) Beneficiaries shall take only if living.

(2) The term "Option" when used herein shall mean the settlement option in, or attached to, any policy referred to herein.

(3) Whenever the context so requires, the plural shall include the singular, the singular the plural and the masculine the feminine.

(4) The term "Insured" as used herein shall include Annuitant, if any policy herein is an annuity contract.

(5) If there is more than one person in a designated class of beneficiaries (whether Primary, Contingent or Second Contingent) the reference in Articles I and II to the death of a beneficiary shall mean the death of the last survivor in such class.

B. **Assignments.** This agreement shall be subject to any assignment of any policy covered herein.

C. **Plural Beneficiaries.** If a class of beneficiaries contains more than one person, the following rules shall apply.

(1) If settlement is to be in a single sum, the class shall take share and share alike, the survivors or the survivor.

(2) If any policy provides by its terms for payment in instalments, the class shall take the instalments share and share alike, the survivors or the survivor.

(3) If the class is entitled to receive under an option, the amount then due shall be apportioned share and share alike, the survivors or survivor.

(4) If the class is entitled to receive under the Interest or Fixed Income Option, and any person in such class shall thereafter die, the sum retained for such deceased person shall be apportioned share and share alike to the survivors or survivor in such class and be paid in like manner and as a part of the sum originally apportioned to such persons.

The provisions of the foregoing paragraph shall not apply in the case of a person who is then entitled by reason of other provisions herein to receive under any option, other than the Interest or Fixed Income Option, and settlement with such person shall be in a single sum.

(5) If the class is entitled to receive under any option, other than the Interest or Fixed Income Option, and any person in the class shall thereafter die, the unpaid instalments certain shall be continued share and share alike to the survivors or survivor.

If it is expressly stated in Article II that settlement with Contingent Beneficiary is to be in a single sum, such stipulation shall govern, otherwise any unpaid instalments certain upon Primary Beneficiary's death (while receiving instalments under any option, other than the Interest or Fixed Income Option) shall be continued to Contingent Beneficiary, share and share alike, the survivors or survivor.

D. Children of Insured. The term "children of Insured" if inserted in Article I in the column entitled "Name," shall include only children born of the marriage of Insured and spouse and Insured's legally adopted children. The word "children" whenever used herein shall not be construed as having the broad meaning of descendants.

E. Grandchildren of Insured. If children of Insured are designated in Article I as "children per stirpes," this agreement is subject to the condition that if any child of Insured shall have died leaving children or a child surviving at the time such child of Insured would have become entitled to payment or income if living, then such surviving children or child shall take in a single sum the share its parent would have received if living.

If any child of Insured shall die while receiving income or instalment payments hereunder, then the amount retained at such child's death, or the commuted value of any instalments certain shall be paid to the then surviving children or child of such deceased child, if any be living, otherwise said sum shall be paid or apportioned to the surviving children or child of Insured as provided herein, except that if any other child of Insured is then dead, but has left children or a child then surviving, such surviving children or child shall take the share its parent would have received if living.

F. **Bankruptcy.** The undersigned certifies that he has not been declared a bankrupt and that no bankruptcy proceedings are pending against him.

G. **Double Indemnity and Dividends.** Unless otherwise provided herein, the phrase "The net sum payable" shall be construed as including any double indemnity benefits and any dividend accumulations payable under any policy covered by this agreement.

H. **Surrender.** Upon maturity or surrender of any policy, the proceeds then payable may be left with the Company under a settlement option if payable to a natural person.

I. **Proof.** It shall be the duty of the person entitled to payment by reason of any succession or change in beneficial interest and/or method of payment to furnish proof to the satisfaction of the Company at its Home Office of the happening of the contingency on which such succession or change is to take effect and the Company shall not be liable for any payment prior to receipt of such proof. The Company in determining the persons comprising any class mentioned herein, the names, addresses, ages and dates of birth, or any facts relating to any persons or beneficiaries mentioned herein, either as a class or otherwise, may rely solely on an affidavit or other evidence satisfactory to it, and is hereby relieved and discharged from any liability and responsibility in making payment in accordance therewith, and in acting in reliance thereon.

J. **Succession to Payments.** Any interest or instalment accruing between the last preceding due date of such interest or instalment and the death of the payee shall be paid to the next succeeding payee, except that any unpaid portion of any continuous instalment due at the death of the payee after the certain period shall be paid to the executors or administrators of the deceased payee.

K. Rights After Maturity. Unless otherwise provided herein, the reservation of rights set forth in Article III-B shall cease at Insured's death.

L. Privilege of Withdrawal. If a payee is given the right of withdrawal, the principal and accrued interest thereon may be withdrawn either in whole or in part, provided the minimum partial withdrawal shall be Two Hundred and Fifty ($250.00) Dollars, but the Company reserves the right to defer payment until ninety days after receipt of written request therefor.

M. Minimum Instalments. If the amount to be placed under a settlement option for any payee is less than One Thousand ($1,000.00) Dollars, the Company reserves the right to make payment in a single sum instead of in instalments, and the Company reserves the further right, if payment of the instalments as provided in this Agreement would be less than Ten ($10.00) Dollars, to make payments at less frequent intervals.

N. Minimum Fixed Income. If payments provided under the Fixed Income Option would amount to less than six per cent per annum of the proceeds originally placed under such option, the Company reserves the right to increase such Fixed Income Payments so that they will be not less than six per cent per annum.

O. Maximum Duration. The Company reserves the right to make payments in a single sum of any proceeds remaining on deposit for Contingent Beneficiary after thirty years following the date of Insured's death.

P. Maturity. Should any policy mature prior to the death of Insured, the amount then due shall be paid as proivded in the policy. If such policy is payable upon maturity in instalments, any unpaid instalments certain upon Insured's death shall be continued when due to Primary Beneficiary, otherwise their commuted value shall be paid to Contingent Beneficiary, otherwise to Second Contingent Beneficiary, otherwise to Final Beneficiary. If the policy permits the beneficiary to commute future instalments, the authorization of the payee then entitled to receive shall suffice. Except as provided in this paragraph, the provisions of this agreement apply only to maturity by reason of Insured's death.

Dated at ______________________________, this ____________

day of ____________________, 19____.

______________________________ ______________________________

Witness *Insured*

3. The Deposit Receipt

(The supplementary contract form used when the payee elects the Interest Option after maturity)

Pol. No. 1 354 786 Cincinnati, Ohio, November 22, 1946

On the life of Roger W. Clark (Amount $5,128.42)

RECEIVED Five Thousand One Hundred Twenty Eight and 42/100 DOLLARS, being the proceeds of the policy or policies listed above to be retained by said Company with interest at a rate equivalent to Two per cent per annum from November 11, 1946, payable monthly to Roger W. Clark, hereinafter called the payee, during his or her lifetime, and on receipt of proof of death of the payee the proceeds then on deposit together with accrued interest thereon as of the date of death of the payee shall be paid in a single sum as indicated under Mode A:

MODE A. To Laura L. Clark (hereinafter called the contingent payee or payees), if living, otherwise in accordance with Mode B.

MODE B. To the executors or administrators of said payee.

If Mode A has been selected, withdrawals will be permitted but only on the JOINT request of both the payee and the contingent payee or payees; but if Mode B has been selected withdrawals will be permitted on the request of the payee alone.

If the right of withdrawal is exercised, the principal and accrued interest thereon may be withdrawn either in whole or in part, provided the minimum partial withdrawal shall be $250.00, but the Company reserves the right to defer payment until ninety days after receipt of written request therefor.

This certificate must be returned to the Home Office of said Company for endorsement on the reverse of any withdrawals permitted by the above election.

Interest instalments will be increased from profits as apportioned by said Company.

THE UNION CENTRAL LIFE INSURANCE COMPANY

By ______________________,

Assistant Secretary

4. Payment Card

Q. 1-11

V A V S V Q V M **INTERESTINCOME** V J V F V M V A V 5 V J V 7 V A V S V O V N V D

Payee No.	Policy No.	Gr.	Br.	R	M	Issue Date	Payee
12902	1197431	1	1	2	3	4-11-41	Lula W. Buechner

Insured: Buechner, Alvin J. (Dec'd)

Entry Date	Cont. Int.	Surp. Int.	Add'n or Withdr.	Balance	Basic Cont.	Basic Surp.	Total	Change On
4-25-41			A W	4,409.33	38.03	--------	38.03	
Mar 22 '43	1.68		A W 250.00	4,159.33	35.87	--------	35.87	
			A W					
			A W					
			A W					
			A W					
			A W					

Guar. Int.	Surp. Int.
3½%	Nil

Claim No. or Source: Death

Elec. by	Form	Withd.
B	SR	Yes

Payment Dates								Remarks
Jul 8 '41								
Oct. 3 '41								
Jan 7 '42								
Apr. 7 '42								
Jul 7 '42								
Oct 6, '42								
Jan 8 '43								
Apr. 7 '43								
Jul 7 '43								

UC 3404 D

M-13

5. Control Card

BENEFIT PAYMENT CONTROL CARD

UC 3411 5-43

Entry Date	Payee No.	Policy No.	Plus New Basic Total	Less Old Basic Total	Balance	Special Instructions See Payment Card	
						Payee No.	Policy No
May 1 '43					9406.32		
5/14/43	04618	811626	V	25.00		13642	855456-A
5-3-43	15162	913344	V	100.00		8408	1317249
Jun 3 '43	17079	1044594	200.00	V			
Jun 10 '43	04206	509923	V	2.50			
Jun 17 '43	13632	935272	V	30.00			
Jun 17 '43	13632	935271	V	10.00			
Jun 22 '43	15162	913344	100.00	V			
Paid 7/8/43					9538.82		
Aug 3 '43	08070	1182243	V	82.67			
Paid 8/6/43					9456.15		
Aug 6 '43	15825	1052459	45.15	22.58			
Aug 10 '43	12637	706527	30.07	V	9508.79		
Aug 17 '43	17442	1182243A	41.33	V			
Aug 17 '43	17443	1182243B	41.34	V			
Aug 19 '43	17304	1309602	V	11.06			
Aug 19 '43	17304	1306756	V	20.39			
Aug 23 '43	13625	667081	V	50.00			
Aug 23 '43	17469	684248	98.23	V			

6. Authorization to Make Annuity Payments to a Bank

As payee under policies 1 245 934 & 1 293 755 issued by The Union Central Life Insurance Company on the life of Roger W. Clark, I hereby authorize that such payments as hereafter become payable to me by the provisions of the said policies, be remitted to the order of The First National Bank, Cincinnati, Ohio, for deposit to my account in said Bank.

Any such check drawn to the order of said Bank shall not be deposited to my account prior to the due date of said check. If any such payment or payments shall be made by said Insurance Company to said Bank, the due date of which payment or payments shall be subsequent to my death, I hereby authorize and direct the said Bank to refund the amount of such payment or payments, and to charge the amount of said refund to my account.

It is understood and agreed that payment as above requested and authorized shall continue until I otherwise notify the Home Office of the said Insurance Company in writing, and I do hereby discharge the said Insurance Company from all liability whatsoever for any payment made to said Bank in accordance with the above request and authorization.

Dated at ____________________, this ________ day

of ____________________, 1947.

____________________ ____________________

Witness

The terms of the above request and authority under which payments due Roger W. Clark shall be made by The Union Central Life Insurance Company are noted, and in consideration of such payments or payment being so made to us, we agree to refund to the said The Union Central Life Insurance Company, any said payment or payments received in accordance with the above request credited to the account of Roger W. Clark, the due date of which payment or payments shall be subsequent to the death of said ______Roger W. Clark.______

Dated at ______________________, this ________ day of ______________________, 19____

By________________________________

APPENDIX C

State Tax Requirements

1. Income Information at Source Requirements by States (a)

(See explanatory footnotes on pages 155-6)

	Effective date of act	Report must be filed by	Amounts that must be reported				
			Profit from matured Endowments when in excess of	Interest paid or credited when in excess of	Instalments and Annuities		
					Taxable portion when in excess of	Basis of determining taxable portions	
						Instalments from death claims	Annuities and other instalments
Alabama	1-1-33	March 15	$500	$500	$500	Federal	Excess
Colorado	7-1-37	February 15	1000	50	1000	Federal	Federal
Idaho (b)	7-1-31	March 15	700	700	700	Not Reported	Excess
Indiana	5-1-33	January 31	1000	300	1000	Not Reported	Excess
Kansas	1-1-34	March 1	750	750	750	Federal	Federal
Kentucky	1-1-36	March 15	600	600	600	Federal	Federal
Louisiana	1-1-34	February 15	1000	1000	1000	Not Reported	Federal
Maryland	1-1-37	February 15	100	100	100	Federal	Federal
Massachusetts	1-1-34	March 1	Not Reported	5	5	(c)	(c)
Minnesota	1-1-37	March 1	100 (d)	100	100	Federal	Federal
Mississippi (e)	1-1-34	March 15	100	100	100	Federal	Excess
Missouri	1-1-17	March 1	1000	1000	1000	Not Reported	Excess
Montana (f)	1-1-33	March 15	300	300	300	Not Reported	Excess
New Mexico	1-1-33	April 1	1000	100	1000	Not Reported	Excess
New York	1-1-35	February 15	1000	1000	1000	Federal (g)	Federal
North Carolina (h)	1-1-37	March 15	1000	1000	1000	Not Reported	Federal
North Dakota	1-1-19	March 15	500	500	500	Not Reported	Excess
Ohio	1-1-32	May 1	Not Reported	(i)	(i)	(i)	(i)
Oklahoma	1-1-35	February 15	850	100	850	Federal (j)	Federal
Oregon	1-1-39	February 15	250	250	250	Federal	(k)
South Carolina	1-1-21	March 15	1000	1000	1000	Not Reported	Excess
Vermont		February 15	100	100(l)	100	(m)	(m)
Virginia	3-1-13	February 15	500	500	500	Not Reported	Excess

Federal. The same method is employed to determine the taxable portion as is outlined on pages 105-6. If, however, the original date of entry precedes the date of the act a special calculation is necessary.

Excess. The instalments are taxable in their entirety only after the total instalments paid exceeds the original cost, prior to which time the payments are not reported.

(a) In addition to the states listed California requires a statement of the total of commuted value of annuity policies paid or refunded residents during the year.

(b) Idaho requires in addition a statement of the total deposits at the end of the year together with the accrued interest thereon.

(c) The total amount of instalments under annuities of settlements involving life contingencies must be reported. In the case of settlements involving only instalments certain, the excess over the original cost only is taxable. In such instances a special calculation is necessary.

(d) Only the profit earned after 1-1-33 is reportable.

(e) Mississippi requires in addition a statement of the total deposits at the end of the year together with the accrued interest thereon, the total policy deposits withdrawn together with accrued interest thereon and the total payments debited to the Instalment and Contingent Instalment Accounts.

(f) Montana requires in addition a statement of the current year's interest paid or credited.

(g) Accounts with an original date of entry prior to 1-1-36 require a special calculation.

(h) The company is required to pay to the North Carolina Department of Revenue a personal property tax of 25¢ per $100.00 of the total sums left on deposit by residents the principal of which is subject to withdrawal, except that the first $20,000.00 of funds are not taxable if payable to the widow or children of the insured whose death created the fund.

(i) There is no minimum upon the amounts that must be reported in Ohio. The total interest, annuity or instalment payments must be reported except that no report is necessary if there is no difference in the payments over those of the preceding year. Special reports are required with each new account. There is no required date for reporting, but the payee must file by March 31. All changes of address must also be reported.

(j) Life incomes with instalments certain call for a special calculation if the original date of entry is prior to 1-1-39.

(k) The actual payments must be reported together with additional required information.

(l) Report interest only if the proceeds are from a source other than death.

(m) The total amount of the payments together with the total consideration must be reported.

2. Inheritance Tax Requirements Under Annuities and Supplementary Contracts

State	If payable to the decedent's estate	If decedent had the right of withdrawal, purchased the contract, elected the option, or was payee under joint and survivorship contract	If payable to a named beneficiary designated by some one other than decedent	Remarks
Arizona	Notice	Notice	None	Ten days before payment
California	Release	Release	None	
Colorado	Notice	Release	None	
Connecticut	None	Release	None	Not required if estate being administered
Dist. of Col.	None	Notice	None	Only if total $300 or more
Hawaii	Notice	Release	None	
Illinois	Release	Release	None	
Indiana	Notice	Notice	None	Ten days before payment
Iowa	Notice	Notice	None	Ten days before payment
Kentucky	Notice	Notice	None	
Louisiana	None	Release	None	
Michigan	Notice	None	None	Five days before payment
Minnesota	Notice	Notice	Notice	
N. Hampshire	None	Release	None	
N. Jersey	Notice	Notice	None	
New York	Release	Release	None	Only if total $200 or more
No. Carolina	Release	Release	None	
Ohio	Release	Release	None	Only if total $500 or more
Oklahoma	Release	Release	None	Only if total $200 or more
Oregon	Notice	Notice	None	Five days before payment
Rhode Island	Release	Release	None	
So. Carolina	Release	None	None	Release required if payable to trustee
So. Dakota	Notice	Notice	None	Ten days before payment
Tennessee	Notice	Notice	None	
Texas	Release	Release	None	
Utah	Notice	Notice	None	Five days before payment
Washington	None	Release	None	Not required if probate under way
West Virginia	Notice	Notice	None	Not required if less than $1000 payable to estate or $1500 payable to relative
Wyoming	Notice	Notice	None	Ten days before payment

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