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Family Law

Securing a Term Alimony Obligation

A properly drafted PSA ensures the proper amount of coverage and avoids post-mortem disputes

By Jonathan W. Wolfe and
Naim D. Bulbulia

Matrimonial attorneys negotiating a Property Settlement Agreement (PSA) requiring their client to maintain life insurance to secure a term alimony obligation must ensure that the PSA is properly drafted to ensure that their client is not providing greater coverage than he or she intends, and to avoid a potential dispute upon the client's death, with respect to the amount due to the surviving spouse.

The preliminary factors that must be taken into account are: (i) the difference in the tax treatment between the receipt of alimony payments and the receipt of life insurance proceeds; and (ii) the difference between the present value of the future support payments for which the insurance is designed to secure and the total sum of each year's alimony obligation. For example, because alimony payments are generally taxable as income to the receiving spouse and life insurance proceeds are

received income tax free, the amount of insurance must be adjusted downward to avoid providing the receiving spouse with a significant windfall. Similarly, because in many instances the policy is designed to secure payments over a number of years, the initial policy should not exceed the present value of these future payments.

For example, assume the PSA will require the wife to pay alimony for a period of 10 years at a rate of \$50,000 per year and the wife has agreed to obtain life insurance to secure this obligation. How much life insurance is required in the first year after the divorce?

Assuming a 35 percent tax rate and a discount rate of 6 percent, the present value of \$50,000 per year payments for 10 years is \$243,910.

After adjusting the insurance obligation to account for the nonincome taxability of the life insurance proceeds and the present value of the support obligation, attorneys must address the fact that the total support obligation should be reduced annually. The wife's security obligation in the example above should decrease as illustrated by the accompanying chart.

Accordingly, if the wife were to agree to obtain and maintain a life insurance policy for the full \$243,910 for the entirety of her alimony obligation, she risks providing her former

spouse with a substantial windfall upon her death. For example, if she were to pass away in the final year of her alimony obligation, the potential windfall to her former spouse could exceed \$200,000.

This potential problem is illustrated in the matter of *Konczyk v. Konczyk*, 367 N.J. Super 512 (App. Div. 2004), in which the PSA required the husband to maintain life insurance of \$15,000 and he died with a remaining alimony obligation of only \$2,000. To complicate matters further, the husband improperly had removed his former wife as a beneficiary of the insurance policy. The wife commenced an action and sought the full \$15,000 insurance proceeds on the grounds that the defendant was required to maintain this amount under the terms of the PSA. Both the trial court and the Appellate Division rejected the wife's argument on the basis that the PSA "clearly and unambiguously used life insurance to secure defendant's limited-term alimony obligation..." The court, therefore, limited the wife's award to the outstanding alimony payments of \$2,000.

Query the result if the husband in *Konczyk* had not removed his former spouse as the beneficiary of the insurance policy. In *Vasconi v. Guardian Life Ins. Co.*, 124 N.J. 338 (1991), the New Jersey Supreme Court was confronted with a situation in which a decedent

Wolfe and Bulbulia are with Skoloff & Wolfe of Livingston.

died with his former spouse named as the beneficiary of his life insurance policy. In carving out an exception to the basic rule that the designation form controls, the Court found the former spouse's waiver of her rights in the PSA to be controlling. It is unclear whether the same result would have been reached in *Konczyk* had the wife remained the beneficiary of the policy at the time of her former husband's death. Indeed, rather than containing an explicit waiver of her rights, the PSA in dispute in *Konczyk* arguably required the \$15,000 insurance policy to be maintained for the benefit of the former spouse.

What is clear is that the failure to appropriately address these issues at the time the parties negotiate the PSA can lead to substantial and unnecessary litigation. The PSA should at a minimum make clear that any insurance obligation is designed solely to secure the remaining alimony obligation. It is certainly better practice additionally to include a specific breakdown (i.e., in the form of accompanying chart) identifying the total amount of proceeds to which the surviving spouse would be entitled each year. The agreement should further allow (but not require) the spouse with the insurance obligation to correspond-

ingly reduce the insurance coverage each year.

Yet another alternative to address the decreasing need for security associated with a term alimony obligation would be to include a provision in the PSA requiring the acquisition of multiple policies with overlapping terms. For example, a PSA could be drafted to require the spouse with the insurance obligation to obtain: (i) a 15-year policy of \$500,000; (ii) a 10-year policy of \$500,000; and (iii) a five-year policy of \$500,000. Thus, if the insured spouse were to die within the first five years after the divorce, the former spouse would receive \$1.5 million in insurance proceeds, as opposed to \$500,000 after ten years.

The most straightforward, accurate, and secure manner in which to address these issues, however, is the utilization of an insurance trust. The trust would be designated as the owner and the beneficiary of the insurance policy. The terms of the trust would require that only the outstanding obligation required to be paid by the PSA be paid from the policy to the ex-spouse, with all remaining policy proceeds payable to the children, trusts for their benefit, or other desired beneficiaries. The trust should contain

the specific present value calculations and payments owed to the former spouse depending on the year of the decedent's death (such as the one detailed above) to avoid any dispute over the propriety of the assumptions and/or calculations. The utilization of such a trust would ensure that the appropriate amount of the proceeds is received by the former spouse, eliminate the administrative burden of having to annually adjust beneficiaries or reduce an insurance obligation, and avoid the type of litigation seen in *Konczyk* and *Vasconi*.

In sum, including a provision in the PSA that simply requires a client to maintain a life insurance policy for a term of years is insufficient to protect a client's interests. At a minimum, the PSA should create a sliding scale of required coverage with a table that indicates the present value (net of income taxes) that is required each year of the term alimony obligation. Further, to ensure that the former spouse does not receive a windfall and to minimize the risks of future litigation, an insurance trust should be utilized to limit the amount of proceeds received by the spouse to the outstanding alimony obligation as established by the PSA. ■