INSURANCE PLANNING

Top Life Insurance Issue for 2017: Cost-of-Insurance (COI) Litigation in Universal Life Policies

By Ben G. Baldwin, Jr.

If you find the name of the life insurance company in the table below that is providing universal life insurance for you, your family or any of your clients, it is likely that the policy has been, is, or will be, subject to cost-of-insurance (COI) litigation. Step one: Call the insurance company and ask if they have been subject to COI litigation and request that an inforce illustration be sent to the policy owner showing current and projected COIs.

Allied Life	Midland National
Allstate	Metropolitan
American Express	Ohio State
Aviva	Nationwide
AXA-Equitable	New York Life
Banner Life	Phoenix
Conseco	PHL Variable
Fidelity & Guarantee	Pacific Life
Guarantee Mutual	Prudential
ING	Security Life of Denver
Jefferson Pilot	State Farm
John Hancock	Transamerica
Lincoln Benefit	Voya
Lincoln Financial	West Bend Mutual
Lincoln National	William Penn
Mass Mutual	Zurich American

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Unlike whole life, which provides a guaranteed death benefit up to age 121 supported by an insurance company guaranteed premium amount stipulated at issue, universal life (UL) is built on hypotheticals. If you want "X" death benefit in a universal life policy, the insurance company/agent recommends what it thinks you should pay in premium to support the desired death benefit. That premium estimate assumes that policy expenses will not increase above current levels and the costs-of-insurance (COIs) will not increase over those projected. It also assumes that the assumed interest rate in the illustration, often illustrated at eight to 10 percent, will stay at the level illustrated. In variable universal life (VUL), the paper illustration, often illustrated at 12 percent, assumes this level of earnings in the policy owner-selected sub-accounts will do 12 percent, year in and year out for thirty to fifty years.

Unfortunately for many universal life policies issued in the 1980s and 1990s, the projected earnings have not been level and have not been as high as those projected. As interest rates came down and expenses and COIs went up, increased premiums were needed to support the death benefit. Policy owners, who were disappointed that policy earnings were less than expected, were unwilling to increase premiums. This caused many policy terminations. When market interest rates went below the insurance company's contractually promised guaranteed minimums, remaining policy owners kept their assets in the guaranteed interest account. Some minimum guarantee accounts promise three to five percent, an amount that is more than what the insurance companies can earn today. These policies have become just as disappointing to insurance companies as they have been to policy owners.

The solution for the insurance companies has been to utilize the flexibility built into these policies. That is, they have raised the expenses in the policy to their contractual maximum and raised the costs-of-insurance (COIs) to no more than their contractual limit. Both acts further increase the premium required to support the death benefit so that the policy survives as long as the insured survives. Most policy owners have little understanding of how this puts the policy at serious risk.

So call the company if you or your client are doing business with a company on that list, as suggested above. You can also research this by using an Internet search engine and typing: "COI Litigation against XYZ insurance company." It would be prudent to do the same thing if you own a universal life policy and the company name is not on the list. This list is dynamic with new litigation against various insurance companies continuing.

To point out the seriousness of class action litigation the class action suit against Phoenix Life Insurance Company and PHL Variable Life Insurance Company was settled just before going to trial for $48.5 million and a COI freeze through 2020. The same law firm that won settlements against Phoenix Life and PHL is litigating four new certificate of insurance class actions against AXA, Voya, John Hancock, and Lincoln.[1]

It is extremely important that advisors be proactive on this issue and contact any clients you have reason to believe may be affected. None of us want anybody asking, "Why didn't you tell me?"

A Variable Source of Help

In late 2016, the American Bar Association published a book by two very experienced Trust Owned Life Insurance (TOLI) advisors, E. Randolph Whitelaw[2] and Henry Montag CFP®, CLTC,[3] *The Life Insurance Policy Crisis*. This book should be a part of every advisor's library who, like it or not, must deal with unhappy life insurance policy owners. Lawyers, accountants, investment specialists, life insurance specialists, trust advisors, trust officers and trustees are all likely to be impacted. The book points out life insurance policies that are particularly at risk, such as Trust Owned Life Insurance (TOLI) and financed life insurance. Trust beneficiaries of policies that have failed because of inattention have shown a propensity to litigate against all the advisors having anything to do with the transaction, the whole advisory team.

Older insureds owning universal life policies issued in the 1980s or 90s (when the ten-year US Treasury Note yield was as high as 15.94 percent and averaged between six and seven percent for the whole period) are more likely to encounter the COI problem. Universal life insurance policy illustrations were generated with interest rates that were impossible to achieve, but appealing to consumers and legally required by the regulators. These illustrations projected these high rates as linear and applicable for the life of the policy. The irony is that these linear illustrations are being created today for UL policies that are being sold with the ten-year note at 2.494 percent.[4] These policy buyers probably are being misled also since the future direction of interest rates generally is up. Using the interest rate du jour for the next fifty years, policies being issued today may out-perform their illustration because of increasing interest rates.

A good bit of the reason for these policy failures is due to the traditional way that life insurance has been sold. Commissioned agents have no contractual post-sale responsibility. Even if the agent was one of the many who do try to provide post-sale counselling, many of those 1980-1990 agents have retired or died leaving policy owners on their own.

If you currently are involved in an increasing COI issue with one of these old policies, you might just jump to Chapter 7 of this book, *Inforce Life Insurance Policy Intervention: Damage Control*. This chapter even provides guidance for your interview with the impacted policy owner with questions to ask, information to obtain and alternatives available to policy owners, such as inforce policy remediation, carrier and/or product restructure, warranted replacement, policy surrender and policy sale, with the risks and rewards of each described alternative.

If a sale of the existing contract is to be considered, fiduciaries should seek out Chapter 10, *Life Settlement Market*. This chapter reviews the evolution of the life settlement market along with a description of viatical settlements. With viaticals, the insuring company advances money from the expected death benefit for expenses after having received evidence that the insured is chronically or terminally ill with a life expectancy of 24 months or less. The advantage of these advancements is that they are, like the death benefit, income tax free. A life settlement is an outright sale to a third party of an existing term insurance or cash value policy for something more than the cash value, incurring income taxes to the extent of gain. Gain is determined by data from the insuring company. The policy's adjusted basis is premiums paid less the value of the life insurance provided up to the settlement date.[5] Guidance is also given in this chapter about life settlement mechanics, when they are appropriate, and a process for trustees and other fiduciaries to go through to avoid problems.

I would add to this list of damage control alternatives. Prior to finally disposing of a contract the policy owner should consider the contractual distribution of policy capital under the "Optional Modes of Settlement" pages. These alternatives tell the policy owner he or she can take the money out of the policy over lifetime with various guarantees such as life and 10 years or 20 years certain, or refund certain. These settlements are surprisingly generous, compared to what is available today for lifetime guaranteed income. At the time the insurance company built these tables into the contract, they did not think people would live as long as they are today, nor foresee how low interest rates would go. To be a positive alternative, we must have a quality company and an annuitant or annuitants who want tax-advantaged retirement income for life with guarantees so that even if they die too soon, the beneficiaries will get money back to the extent of the guarantee.

This book provides not only great assistance when you are under the gun with a problem policy, but it also provides guidance to avoid those problems in the future through proper set-up and administration of life insurance owning trusts. See Chapter 11, *How Can Irrevocable Life Insurance Trust (ILIT) Fiduciary Practices Demonstrate and Document a Prudent and Reasoned Process?*This chapter lays out how to do it for the drafting attorney, the ILIT trustee, and the life insurance agent/advisor. It also provides a valuable Beneficiary Protection Checklist applicable to all members of the estate planning team. Chapter 13, *ILIT Litigation: Process over Performance Best Practices Litigation-Tested Guidance* builds on Chapter 11 by providing ILIT guidance based on the background of the authors' expert witness work, with examples of what went wrong and how the mistakes could have been avoided.

Chapter 15, *Sample Documents*, provides sample documents for life insurance planning and goes through a checklist-like process listing all the things an advisor will want to address leading up to a life insurance purchase and a request for proposals (RFP). RFP forms for various situations such as old age or impaired risk of the client, are provided. A Life Insurance Policy Statement (LIPS) will be helpful for investment managers for life insurance-owning trusts and specifically for ILITs. The sample letter from the insured grantor of the ILIT to the one who will be the trustee is very valuable. It lays out the process that took place during the purchase of the life insurance on the grantor's life and in setting up the ILIT. The letter identifies all the parties involved and who will be responsible for what duties in the continued administration of the trust. A two-page life insurance Product Suitability matrix is like a very helpful agenda for the insurance specialist and the parties to review all of the various life insurance alternatives available, the risks and rewards of each and the ongoing management requirements of the various life insurance product type.

Chapter 16, *Referenced Articles* provides an extensive list of articles, news stories and books authored by others, as well as previous publications of these two authors. It provides what amounts to a searchable check list. Find the title of the topic you are researching among the listings, do an Internet search for the authors name and the article title and, in most cases, the writing you are searching for will pop-up.

Chapter 17, *Sample Life Insurance Cases* provides guidance for advisors dealing with how inattention, such as not knowing that the insured has quit smoking, can be costly. Guidance is provided for replacement or remediation of variable universal life (VUL) policies, such as restructuring a VUL policy for suitability reasons. Also provided is information about the use of fee-based life insurance consultants, viatical of an unaffordable life insurance policy, and dispute resolution.

The final chapter, Chapter 18, *Contributed Articles*, contains the writings of fellow professionals and the life insurance issues that those professionals feel need the attention. Such things as trustee appointment issues, commissioned sales people, dealing with lawyers, long-term care insurance riders and their tax consequences for trusts, replacements, and the good, the bad, and the ugly of individual, as opposed to corporate, trustees.

One lengthy offering in Chapter 18 is by one of my favorite actuaries, Christopher H. Hause, FSA, MAAA. Favorite because he developed, along with another favorite, Dick Weber of the Ethical Edge, a software tool that provides unique insight into the risks and potential rewards of life insurance that is not only valuable to professionals, but also to the consumer. They have donated the current version to the Society of Financial Services Professionals. It is available to all Society members, all of whom would be happy to use it to assist fellow professionals with its use.

As good as this software is in its current version, it isn't as good as it must be to replace the multi-page, linear, printed, legally required illustrations that are consumer mind-numbing and misleading. The software was great in its original version, which was dynamic and visual. I used it to teach clients and professionals what happens when any of the non-guaranteed elements of their universal life policy, particularly a variable universal life (VUL), was less than the frequently illustrated 12-percent linear for 50-year paper illustration. I could, in the consumer's presence just change the interest rate, change the expenses, change the premium, change the death benefit one at a time and the picture of the death benefit and cash value in the dynamic illustration would immediately change. The consumer could immediately see how each change impacted the survivability of the policy. I would, for example, change the interest rate from 12 percent to 11.9 percent and my audience would gasp as they saw the dramatic ending value drop. Then I would increase premium and they could see how that could improve the situation or what reducing the death benefit would do for policy survivability. The software could also access year-to-year stock market scenarios embedded in the software and the consumer would watch as the dynamic illustration did 100 or 1,000 tests showing the cash value line flashing up and down helping the consumer understand the impact of equity market volatility better than any tool available today. Unfortunately, the original version is not available at this time.

As I understand it (I'm sure Chris and Dick will let me know if I am wrong), they sold the copyright for the original software to Financial Profiles back in quieter times when paper illustrations were not out of favor and regulatory approval of the dynamic illustration system was unlikely. Financial Profiles has put it on the shelf and, despite repeated attempts to get them to revive it, they have done nothing. Financial profiles should hire Dick and Chris to revive The Dynamic Illustration System and, also have them take it to the regulators, SEC, FINRA and the National Association of Insurance Commissioners (NAIC). Their professional reputations are such that they would be welcomed. The regulators today are in the middle of this life insurance policy crisis, and are aware of the severe shortcomings of paper illustrations built back in the era of just whole life and term insurance. These illustrations cannot adequately communicate an understanding of the impact of changes in the non-guaranteed elements in universal life, variable universal life and the multiple variables in indexed universal life. If Financial Profiles does not want to do this they should, for the good of the industry, take a tax write-off and donate it back to Chris and Dick.

The Life Insurance Policy Crisis book by Whitelaw and Montag will certainly help all advisors survive the crisis and be better prepared for the inevitable coming crisis because of the mind-numbing complexity of the often misunderstood, currently popular, Index Universal Life. As the law firms are saying; "We are also investigating reports that life insurance companies provide promotional and other material to customers to mislead them about the risks related to universal life insurance policies."[6] Index Universal Life manufacturers, sales people and advisors should be wary of the mind numbing complexity of this product and its often misleadingly simple sales message.

ENDNOTES

1 http://susmangodfrey.com/practice-areas/insurance/insurance-class-actions/

2 www.TrustAssetConsultants.com for a discount code and order form.

3 www.TheTOLICenterEast.com.

4 www.cnbc.com/quotes/US10Y.

5 Internal Revenue Bulletin 2009-21 (May 26, 2009)

6 http://www.girardgibbs.com/universal-life-insurance-cost-insurance-lawsuit/