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# The Life Insurance Policy Lapse and Litigation Crisis: What CPAs Need to Know in Order to Avoid a Client Crisis and Create a Glide Path to Safety

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**Introduction**

After more than 35 years of "buyer beware" warnings, why do consumers continue to purchase flexible premium non-guaranteed death benefit life insurance products for a 10 to 50 year planning duration period, assume policy performance risk without knowing the risks to be managed, and forego annual policy performance monitoring—all while knowing there is a high probability that the policy will lapse without value during their lifetimes?

Most policy owners—including Irrevocable Life Insurance Trust (ILIT) trustees, grantors, and beneficiaries—are unaware of the universal life (UL), variable universal life (VUL), and equity indexed universal life (EIUL) policy risks and the need for attentive and credible (dispute defensible) policy risk management in order to realize the life insurance planning purpose. What purpose is served when the planning need cannot be achieved, and when there is no return on a significant cash flow investment?

Lapse also brings into question the sales agent's suitability determination, use of carrier illustrations for predictive value purposes, and communication of product risk and related management disclosures. Sales agents determined the projected policy-crediting rate, giving rise to the "win the illustration beauty contest" description of the policy sales process. The result is that many UL, VUL, and EIUL policies sold over the past 35 years were illustrated at "aggressive" crediting rates that exposed the policy to a risk of lapse without value prior to the insured's assumed mortality, unless the policy has been attentively and credibly risk-managed. Such marketing practices can be described as deceptive, misleading, or predatory. It is important to note that—with the introduction of "buy term and invest the difference" non-guaranteed life insurance products—sales agents, accustomed to selling guaranteed products, experienced a marketing paradigm shift with the responsibility to understand and communicate risk management policy variables.

Lapse without value, especially lapse of a policy insuring a senior over age 70, is accompanied by escalating litigation. These are sophisticated products, but that sophistication does not include self-management. As a result, risk management intervention is needed, and it should take a known, dispute defensible form.

Equally important, intervention should also credibly test different policy crediting rates, cost of insurance charges, and life expectancy scenarios—these variables and planning objectives continually change. The analytic tools are readily available to evaluate different policy management scenarios in order to maximize the probability of a favorable life insurance planning outcome; however, they are often not used for reasons that make little sense.

**Misleading and Questionable Sales Practices**

This crisis started when flexible premium non-guaranteed death benefit policies were introduced, replacing fixed premium guaranteed death benefit whole life policies. The prime borrowing interest rate was 21.5%, as compared to the previous high of 12.5%. This new product type was being illustrated at constant 11-13% or higher policy crediting rates for a 20-to 50-year time horizon. Illustrated policy cash values and policy duration sustainability were known to be unachievable if rates decreased, unless illustrated premiums were increased—meaning annual or periodic policy performance monitoring and periodic premium adjustment (increase) were essential to avoid lapse. Life insurance agents and issuing carriers, however, were not accustomed to providing post-sales policy management services. For questionable reasons, the needed services still are not offered, which is problematic for sales agents held to a standard of competency, suitability, and expected to act in the client's best Interest. Life insurance advisors are expected to be aware of the policy risks, the cause of these risks, and the appropriate process for credibly identifying and managing these risks.

**Action Must Be Taken**

Intervention in the context of this article should take two forms: (1) implementation of annual policy performance monitoring and credible risk management and (2) active interface among the policy owner's legal, tax, investment, and life insurance advisors. Specific to the risk management of flexible premium non-guaranteed death benefit policies is "knowable information" that the Society of Actuaries, flexible premium policy illustrations and policy contracts, professional associations (such as the Society of Financial Service Professionals), and regulators (such as FINRA) opine should not be used for predictive value or policy comparison determinations. Priority must be given to a credible risk assessment of policy performance and the probability of achieving the policy owner's current objectives and planning time horizon. Legal, tax, and investment advisors should be provided with this report so that their collaborative planning roles can be updated.

**Evaluation of Life Insurance**

Evaluation should be unbiased, credible, impartial, and based upon objective data. It should use actuarial evaluation employing generally accepted actuarial methods, quantitative, measurable benchmark comparisons, and Actuarially Certified Benchmark policy standards.

**Actuarially Defensible Policy Evaluation**

A credible option to carrier illustrations has been available for many years, but it has not been offered through the traditional carrier, sales agent, brokerage general agent, producer group, or third-party illustration-based administrator (TPA) distribution channel. Intervention is needed to safeguard the planning purpose and avoid unintended consequences. Actuarial evaluation uses generally accepted actuarial methods, impartial analysis, and objective data to assess the probability that an illustration's scheduled premiums will successfully sustain the policy to insured life expectancy or contract maturity. Said differently, it assesses the probability of a successful outcome—as defined by the policy owner or trustee.

**Intervention—Key Questions for Consideratio**n

- Why has annual or periodic policy performance monitoring and risk management been neglected? Is the policy owner aware that policy performance monitoring and risk management are solely the responsibility of the owner?
- Since the sales agent made a determination that the product recommendation was suitable for the prospective purchaser, did the agent provide a suitability letter explaining the risks that need periodic review, the limited post-sales services provided by the issuing carrier and the agent, and the need for third-party provider engagement to provide the annual performance monitoring function?
- Does the sales agent maintain a professional relationship with the owner or insured, and—if yes—has the need for credible policy risk management been discussed and third-party provider recommendations made?
- Has the planning purpose changed and, if so, does the life insurance product—as well as in-force policy—remain suitable? If yes or no, why?
- What is the age and health of the insured?
- What is the current premium payment risk tolerance of the policy owner? Is the owner still comfortable with a flexible premium non-guaranteed death benefit product and the probability of needing to increase the scheduled premium to sustain the policy to either contract maturity or insured life expectancy?
- Is the owner aware that they are 100% responsible for the performance and ongoing monitoring of policy?

**The Intervention Process**

Following is a checklist of the needed intervention steps that can also be applied to policies owned by trusts, businesses, individuals, and charities.

Formalize a Life Insurance Policy Statement that

- updates the plan's current death benefit requirement,
- summarizes the planning and management process and their respective responsibilities to the parties,
- sets out risk management criteria for carrier and product suitability determinations,
- identifies the life insurance product and policy evaluation duties and how they will be provided,
- establishes vendor screening requirements for delegated life insurance product expertise and periodic performance monitoring functions, and
- affirms annual policy performance monitoring communication requirements.

At the same time, obtain the underwriting carrier's current Comdex ranking along with an actuarially certified policy evaluation that calculates the following data points:

- percentage probability that continued payment of currently scheduled premium will sustain coverage to insured life expectancy (as a minimum), as well as contract maturity,
- earliest insured predicted lapse age and concentration of predicted lapse ages,
- policy standards pricing deviation (i.e., cost of insurance and expense charges as compared to product standards benchmark), and
- correcting annual modal premium to sustain the death benefit protection to insured life expectancy and contract maturity.

Based upon this current assessment of planning objectives and in-force policy evaluation, a risk mitigation plan can be implemented to safeguard the interests of the policy owner, beneficiaries, and advisors. Based upon implementation of a reasoned risk management process that provides for delegation of the expertise functions that the policy owner or trustee lacks, lapse can be avoided, informed suitability and risk management determinations can be made annually, and remediation or restructure can be undertaken as needed. The tools for prudent life insurance policy risk management are readily available—they just need to be used.

**Intervention—Legal and Tax Advisor Role**

The logical intervention source is the policy owner's tax or legal advisor working in collaboration with an experienced fee-based life insurance advisor—not to be confused with a commission-motivated life insurance agent. To avoid fixing a problem by creating another problem, a request for proposal process should be used to ensure that an objective, unbiased consultant is engaged and a credible policy evaluation will be provided.

Priority should be given to the following:

*NGDB, or Non-Guaranteed Death Benefit policies insuring seniors 70 and older.* Issuing carriers are increasing cost of insurance charges—the older the insured, the higher the incremental cost increase, meaning a related premium payment adjustment is necessary to sustain coverage to the policy's sustainability objective.

*EIUL, or Equity Indexed Universal Life policies.* The AG49 lookback rate should be considered as a minimum; however, Monte Carlo Simulation and Actuarially Certified Policy Standards analytics are preferable and avoid AG49 calculation shortcomings.

*VUL, or Variable Universal policies*. Monte Carlo Simulation and Actuarially Certified Policy Standards analytics can evaluate the premium requirement and policy sustainability of different asset allocations over different insured lifetime periods, based upon the policy owner's risk tolerance.

*Unneeded policies*. The Settlement Market can be an attractive alternative to policy surrender or policy lapse without value.

*Restructured policies*. Impaired risk medical underwriting methodology should be considered for seniors if a policy type change is needed. This approach screens for the more favorable carrier or product prior to formal application submission.

**Conclusion**

Intervention is defined as "action taken to improve a situation." Doing the right thing in the right way—and with the right information—has been an available option for many years. The process to prudently purchase and manage life insurance is no different from the process for fixed income and equity investments, and the necessary tools are readily available.

Delegation plays an important role in the intervention process because consumers and professional advisors often lack life insurance product and policy evaluation expertise. A fresh look at product suitability is needed as the range of guaranteed and non-guaranteed products expands, and retention-priced policies are more consumer-favorable than replacement-priced policies. Fee-based, unbiased consultants and third-party policy risk management platforms are available to resolve the shortcomings of the traditional retail distribution channel.

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*The authors' recently released book,* The Life Insurance Policy Crisis – The Advisors' and Trustees' Guide to Managing Risks and Avoiding a Client Crisis*, which was published in October 2016 by the American Bar Association, discusses the lapse and litigation crisis in detail and sets out a prudent practices intervention guide that meets a dispute defensible standard. Further, the book is accompanied by the co-authors' offer to provide CLE & CE continuing education programs, designed for bar associations, society of CPAs, and estate planning councils.*

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