WOLF AMONG THE LAMBS – THE SALE OF EQUITY INDEXED ANNITIES TO SENIOR CITIZENS

By
Robert S. Gianelli
Gianelli & Morris, L.C.
Los Angeles, California

I. INTRODUCTION

In the late 1990s, the sale of deferred annuities began to rapidly expand. Sales in California alone went from $4.6 billion a year in 1998 to $22.6 billion in 2002. The rapid expansion of this market is attributed to a growing senior population with a larger asset base, the downturn of the stock market, and the emergence of high-commission, equity-indexed annuities.

These very ingredients also provided an environment for widespread financial fraud in the sale of the annuities to a vulnerable senior population. Seniors became targets of various schemes devised to get insurance agents into their homes to close annuity sales. Trust mills—organizations run by insurance agents to peddle living trusts for the sole purpose of fraudulently selling annuities to senior citizens—began popping up all over the state. *See*, *e.g.*, *People v. Fremont Life Ins. Co*. (2002) 104 Cal.App.4th 508. Agents have used various other means to pry money from seniors for annuities, such as falsely advising them that placing money in annuities would make them eligible for Medi-Cal, convincing them to take out reverse mortgages to fund annuity purchases (when any benefit from the annuity will never reach the amount needed to pay the debt created by the mortgage), and using the false promise of a "bonus" to induce seniors to cash in their existing investments for an annuity.

California has enacted a variety of laws over the years in an attempt to curtail the deceptive practices committed by agents selling annuities to seniors. (Cal. Ins. Code section 785, which imposes an additional duty of good faith and fair dealing on

insurers and agents selling insurance to seniors; Cal. Ins. Code section 787, which mandates that certain disclosures must be made by agents soliciting annuity sales from persons age 65 or older; Cal. Ins. Code section 798.8, which requires agents to advise senior purchasers in writing of any penalties associated with cashing out on existing investments to buy a life insurance or annuity product; Cal. Ins. Code section 798.10, which mandates certain written and oral disclosures be made before and during in-home meetings by agents soliciting life insurance and annuity sales from senior insureds). Despite these laws, annuity sales abuses against seniors continue.

II. DEFERRED ANNUITIES - WHAT ARE THEY?

In a fixed, deferred annuity, a purchaser deposits a premium and receives a rate of return, the realization of which is deferred until the term of the annuity. At the annuity term, the purchaser has the option of "annuitizing," that is, receiving periodic payments at a set interest rate. Surrender charges, which decrease over time, are imposed for early withdrawal. The rate of return is typically guaranteed for the first year, and then subject to a minimum guarantee (usually a much lower rate) over the term of the annuity.
The deferred receipt of monies is what distinguishes this type of an annuity from an immediate annuity. An immediate annuity makes a stream of payments that begin upon purchase and at a set rate. In fact, the annuitization option of a deferred annuity is simply the ability to buy an immediate annuity. The election of annuitizing a deferred annuity results in the issuance of a separate contract. Statistics show that the annuitization option of a deferred is rarely selected, as these products are designed and sold for retirement/asset-accumulation purposes.

III. THE RISE OF EQUITY INDEXED ANNUITIES

A variant of fixed deferred annuities are "equity-indexed" annuities. These are deferred annuities that tie their returns to stock market indexes, such as the Standard & Poor's

500. They are sold with the representation that the purchaser will enjoy the upside of stock market gains and no loss of principal.

However, insurers do not invest these monies in stock indexes. Rather, they buy options to hedge against stock index upswings. Because a limited amount of money is available to purchase these options—the equivalent of what the insurer would pay as an interest rate return—insurers use "levers" in the contracts to limit any stock index gains.

Early index products had one lever, a "Participation Rate," which was expressed as a percentage of the index gain. For instance, a 9% index gain in a product with a 90% participation rate would result in an 8.1% gain in a given year. Subsequently, when insurers were unable to deliver market-type returns they had advertised and lowered participation rates below 70%, consumers were able to note this change and sales suffered. This caused insurers to add more levers, an "Index Margin," which is a percent that is subtracted from a gain, and an "Index Cap," which sets the upper limit of a gain. Thus, insurers often tout a 100% participation rate but fail to note that other levers in the contracts will be used to accomplish the same result as a reduced participation rate.

Use of multiple levers makes it virtually impossible for a consumer to ascertain the value of an index product at the time of sale or at any time during the contract's term. The disguising of the products' value allows insurers to offer high sales commissions to the agents, as consumers are unable to discern that their premium, and so the returns have been adversely affected by commissions.

IV. COMPETITION AND DECEPTIVE SALES PRACTICES

Annuity premiums generated from California sales jumped from $4.6 billion in 1998 to $22.6 billion in 2002 and have remained in the $22-25 billion range since that time.

To compete for this business, insurers have used a variety of methods to gain access to seniors. The insurers who have been the most active in this market do not operate through

captive agents. Rather, they use sales distribution systems with national marketing organizations, or NMOs, who act as wholesalers, recruiting the sales agents who sell the products to the public. To attract the NMOs and their agent forces, insurers offer high sales commissions.

> We aggressively recruit new agents and expect to continue to expand our independent agency force . . . . These organizations [NMOs] typically recruit agents for us by advertising our products and commission structure.

2003 10-K filing of American Equity Investment Life Insurance Company

The availability of high sales commissions, and the vulnerability of seniors, have created a perfect environment for deceptive sales practices. Realizing they can make up to 12%-15% of any premium collected for spending two to three hours with a senior, unscrupulous sales agents have used a variety of methods to convince seniors to place their savings in equity indexed annuities.

A. Trust Mills

Many insurance agents "specialize" in sales to seniors. They offer "free" seminars on estate planning/asset protection through the use of a living trust. The trust pitch, however, is just a subterfuge for the agent gaining access to a senior's financial information. To complete the living trust application, a senior is required to list his assets. When the assets are reviewed, the agent advises the senior that the investments are unsafe and/or under-performing. An equity indexed annuity is then pitched as allowing participation in the upside of the stock market without any loss of principle.

B. Bonus Products and Replacements

Another incentive, for both the selling agent and the purchasers, is the promise that a bonus will be given. Insurers use the lure of a bonus to represent some type of immediate gain the purchaser will receive.

> Immediate 10% growth.
> You receive a 10% bonus on all funds paid into your policy during
> the first policy year, for an immediate gain on your money.

Allianz Life Bonus Maxxx brochure.

The bonus typically takes the form of a lump sum (5%-10% of the premium) credited to the account value at the time of purchase. The bonus is used to generate sales through the misapprehension that purchasers are getting extra premium contributed by the company. This ersatz value is often represented as a way for purchasers to recoup any monies lost through the surrender of an existing annuity or other investments.

> Bonus annuities can help recoup losses from:
> • CD penalties for early withdrawal
> • Mutual fund losses
> • Annuity surrender charges...
> Bonus annuities can provide an extra measure of comfort to clients who are nervous about the market. They offer an impressive combination of immediate gratification and long-term safety.

Allianz Life Bonus Annuities agent-only brochure.

In reality, any purported bonus disappears either through the application of surrender charges before the annuity term or through the meager returns credited to the annuity by the insurer in the event the purchaser actually endures the lengthy deferral period.

C. Taking Out a Reverse Mortgage to Buy an Annuity

When confronted with cash-poor but home-equity-rich seniors, some agents convince the seniors to take out a reverse mortgage on their home and use the funds, or most of them, to buy an equity-indexed annuity. However, because of the high costs and consequent low returns provided by these products, the investment never catches up with the increasing debt caused by the reverse mortgage, putting the senior in a lose/lose position.

D. Commissions—Whose Money Is It?

As stated above, there has been intense competition among annuity insurers to entice independent agents to sell their products to those in or approaching retirement. The primary

bait used to attract agents, of course, is the commission rate a company will pay. Because the opaque nature of equity index contracts makes it impossible for purchasers to assess how their investment is being affected by commissions, annuity insurers have engaged in bidding wars for agents on commission rates. The resulting exorbitant rates not only serve as the motivation for the various frauds perpetrated in the sale of annuities, but also form the basis of an independent misrepresentation regarding the products.

There is no question that paying a high commission to the agent comprises the annuity purchaser's investment. If a purchaser deposits a premium of $100,000, and the insurer pays the agent a 12% commission, the insurer is left with $88,000 to invest and provide a return to the purchaser. Had a reasonable commission of 3% been paid, the insurer would have had $97,000 to invest.

Sellers of high-commission annuities to seniors have a duty of good faith at the point of sale. Cal. Ins. Code section 785. This duty undoubtedly includes the duty to make a disclosure that the invested premiums are being materially comprised by an inflated commission to the disadvantage of a senior.

V. SURRENDER PENALTIES

Because equity indexed annuities carry high commission costs and typically a "bonus," insurers must recover these costs in the event the purchaser leaves (surrenders) the contract. Consequently, these products carry high surrender charges that apply over a lengthy period of time. For instance, certain high-commission 10% bonus products have surrender charges that start at 20% and graduate down over a 14-year period, making the investment highly illiquid.

Because these constraints on liquidity make the products unattractive to seniors who may need access to funds for medical expenses, assisted living, or for other reasons, insurers use complex language and confusing formats to disguise the penalties. As an example, in

People v. Fremont Life Insurance Company, supra, 104 Cal.App.4th at 517-518, the insurer made the amount of the surrender charge sound as if it was lower than it actually was by classifying part of it (5%) as a premium charge, described in a different section of the policy. The court invalidated the extra charges because the insurer had marketed an annuity policy that was misleading and deceptive in its failure to clearly describe the full economic consequences of early withdrawal of funds and was therefore likely to deceive."

Because surrender charges are forfeitures, they are subject to contract interpretation rules that require greater clarity and prominence than other contract provisions. For instance, in California, such penalties must be set forth in a plain, clear, and conspicuous fashion. Cal. Civil Code section 1442; Croskey *et al.*, California Practice Guide: Insurance Litigation (The Rutter Group 2013), section 6:563.

There may also be laws that are specific to annuity sales and/or to sales to seniors that require the contracts to comply with certain mandates. California Insurance Code section 10127.10(c) requires insurers selling annuities to senior citizens in California to place a notice regarding surrender penalties in 12-point bold print on the cover page or policy jacket of the annuity. Insurance Code section 10127.13 requires insurers to either disclose the surrender period and all associated penalties in 12-point bold print on the cover sheet of the policy or disclose the location of the surrender information in bold 12-point print on the cover page of the policy.

The statutes create a greater duty, based upon a public policy, to provide a specific prominent notice to prevent seniors from searching for penalty language buried in the pages of the contract. This duty is read into the contracts as a matter of law. An insurance policy is governed by the relevant statutory law in force at the time the policy is issued; such provisions are read into the policy and become part of the insurance contract. *Modglin v. State Farm* (1969) 273 Cal.App.2d 693, 698. This is true of statutory notice requirements. *Kotlar v.*

Hartford Fire Insurance Company (2000) 83 Cal.App.4th 1116, 1120-1123 (insurer could not enforce the contracts termination provision because it failed to provide the required statutory notice of termination).