

Deceptive Practices in Sales of Deferred Annuities to Senior Citizens

By Robert S. Gianelli

Abuses in sales of deferred annuities to senior citizens have become a growing problem in California and across the country. Insurance companies have seized on the opportunity of the growing senior market to sell deferred annuities to the elderly. Insurance companies realized that the senior population represents billions of dollars in assets that can be shifted to deferred annuities – products which may be highly inappropriate for seniors given the surrender penalties they carry and the meager returns they provide. To sell these inappropriate products to seniors, insurers have subjected seniors to various deceptive sales tactics designed to conceal the annuities' negative aspects.

Fixed, Deferred Annuities

In a fixed, deferred annuity, a purchaser deposits premiums 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. Surrender penalties can start as high as 25% and last for 15 years. The rate of return is typically guaranteed for the first year, 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 on a deferred annuity is simply the ability to buy an immediate annuity. The election of annuitization of a deferred annuity results in the issuance of a separate contract.

Statistics show that the annuitization option of a deferred annuity is rarely selected.

A variant of the fixed, deferred annuity is the so-called "equity indexed" annuity. This type of annuity functions in the same manner as a fixed, deferred annuity but ties its returns to stock market indexes such as Standard & Poor's. It is typically sold with the representation that the purchaser will enjoy the upside of stock market gains and the downside protection of a minimum guarantee. However, insurers do not invest these monies in the indexes. Rather, they buy bonds and use stock options as a hedging device. The returns on the annuities are also subject to various limitations on index gains at the option of the insurer, subject to the minimum guarantees.

Deferred annuities present a substantial risk of loss to seniors because they are long-term and largely illiquid investments. Seniors who may need access to their money for health or other age-related reasons are exposed to losing a significant percentage of their investment through surrender penalties. Additionally, many of these products apply a penalty on death, thereby depleting the senior's estate.

The Senior Market

As indicated in the California Department of Insurance's 2006 Life and Annuity Market Share Report, national annuity premiums increased from \$49 billion to \$201 billion between 1999 and 2002. This substantial increase in annuity premium is attributed to a downturn in the stock market following the Internet bust. Insurers used this event to promise purchasers that they could not lose money on annuities



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and that their investment would continue to grow over time.

Much of the money available for transfer into annuities was in the hands of senior citizens. Insurers were keenly aware of the assets held by seniors and the opportunity to use the fear of an uncertain stock market to shift billions of dollars into their annuity products. ("We believe that significant growth opportunities exist for annuity products because of favorable demographic and economic trends. According to the U.S. Census Bureau, there were 35 million Americans age 65 and older in 2000, representing 12% of the U.S. population.")¹

But insurers needed agents who could gain access to seniors and sell them their annuity products rather than those of other companies who were also competing for this lucrative business. To recruit agents to sell to seniors, companies set up sales distribution systems with national market organizations, or NMO's, who acted as wholesalers, recruiting the sales agents who would sell the products to the public. To attract the NMO's and their agent forces, these insurers have offered high sales commissions. ("We aggressively recruit new agents and expect to continue to expand our independent agency force.... These organizations [NMO's] typically recruit agents for us by advertising our products and commission structure....")²

The insurers not only provided a healthy financial incentive to the agents, they urged them to target seniors for annuity sales. Agents were told to set up senior "seminars" and to otherwise engage seniors for the ostensible purpose of advising them about their financial security but with the real objective of selling them annuities.

The Deceptive Sales Tactics

Motivated by the high commissions offered by annuity companies, sales agents have devised various means to gain access to unsuspecting seniors. One scheme is using the sale of estate planning services, principally living trusts, to seniors as a pretext to an annuity sale. Agents solicit seniors to buy living trusts for the ostensible purpose of protecting their assets. Through this process, the agents discover the nature and extent of the seniors' assets and then convince them to use that money to buy annuities. The agents and organizations operating in this fashion are known as "trust mills." As stated in a 2001 Notice issued by the Department of Insurance:

Trust mills typically use both licensed and unlicensed representatives, and often operate in conjunction with attorneys or attorney reference services in order to give the operation the appearance of legitimacy. After the living trust and related estate planning documents have been sold, a representative, usually a licensed agent, again misrepresenting his or her identity and purpose, attempts to sell an annuity to the client as part of their estate-planning program. Clients characteristically perceive the agent as their legal advisor or estate planner and not an insurance agent.

The actions of one large trust mill became the subject of an action brought by the Attorney General under California's Unfair Competition Law ("UCL"), Cal. Bus. & Prof. Code section 17200. (*People v. Fremont Life Insurance Company* (2002) 104 Cal.App.4th 508.) The unfair business practices centered around the insurer's improper sale of living trusts through its authorized agents and its use of deceptive policy language to hide surrender charges. Fremont Life entered into arrangement with an organization called the Alliance for Mature Americans ("AMA"), which was actually an insurance agency functioning

as a trust mill. AMA recruited and trained sales agents to sell trusts and annuities to senior citizens. AMA advertised living trusts, as an asset protection device. When a senior would make an inquiry about a trust, an agent would be given the "lead" to sell the trust. If a trust was purchased, the agent would have the senior fill out various forms which required disclosure of the senior's assets. After the trust was created, the agent would deliver it to the senior purchaser and then review the senior's assets listed in the trust. At that time, an annuity was pitched.

AMA first solicited potential consumers through mass mailings or telemarketing techniques, offering free consultations about living trusts in their residences. An AMA representative would then visit a prospect and identify himself or herself as a "certified trust advisor" or as an expert in estate planning. The representative would offer to sell the prospect an estate plan, which would include standardized forms, many of which were based on California statutory forms but without cautionary and instructive information. The documents included an inter vivos trust, pour-over will, and various powers of attorney. When the documents were delivered at a later date, the representative presented the documents for signature and notarized some of them. During this encounter, the person delivering the documents, who at that point was a life insurance agent of appellant, would engage in efforts to persuade the consumer to purchase an annuity policy.

(*People v. Fremont Life Insurance Company, supra*, 104 Cal.App.4th at 512.)

The court also imposed liability on Fremont Life for hiding part of the surrender charge. Fremont Life added an extra 5% to the surrender penalty but did so in a separate section of the policy entitled "premium charge." The court upheld a finding that this was a deceptive act under the UCL. (*Id.*, 104 Cal.App.4th at 519-520.)

Another large and lucrative trust mill was exposed in *Cheves v. American Investors Life Ins. Co., et al.*, Case No. CV031024 (San Luis Obispo Sup. Ct.), a class action brought against American Investors Life Insurance Company and an agent/trust mill known as Family First. Upon the demise of AMA, two of its

former agents sought to build a better mousetrap. They started a new company, "Family First," and patterned it after AMA. They hired other former AMA agents, copied many of the AMA form documents and used many of the AMA sales techniques. Even though Family First was soliciting senior citizens to buy trusts and annuities in the same fashion AMA did, it tried to create the appearance of legitimacy by running Family First's trust sales through Group Legal Services, a purported group prepaid legal plan, and by calling those sales "estate planning memberships."

American Investors Life authorized Family First agents to sell its annuities. American Investors Life was focused on the sale of annuities to seniors and did business with other trust mills. The company had become aware of the abuses committed by trust mills and considered their use in annuity sales to be a "hot button" issue. Nevertheless, it financed Family First's expansion in California and other states. It also secured an option to buy Family First which it later exercised.

As with AMA, the Family First agents were provided leads to sell living trusts to seniors. During the in-home meeting, the agents would make a presentation which stressed the legal differences between a trust and probate and the purported advantages of the trust legal device over the supposed disadvantages of probate. The agent would elicit financial and other information from the senior for the completion of legal documents for the trust and record it in Family First form questionnaires.

In true trust mill fashion, Family First used the trust sale as the door-opener for annuity solicitations. Seniors were not told that the delivery of their asset-protecting trust would be turned into an annuity solicitation. During the delivery, the Family First agent would go over the trust document, notarize it and then transition to an annuity sales pitch.

To sell the annuities, agents used standardized sales presentations. One was called the "7 Page Presentation" in which agents would make a variety of representations regarding the annuity, comparing it favorably to money in banks or in the stock market. During this presentation, agents would attempt to scare seniors by falsely describing the risks associated with these other investments and analogizing

them to certain portions of a house (e.g., an annuity is safe and is like the foundation of a house; a stock is unsafe and is like the attic which is the first thing to come down in an earthquake). Agents would also make representations with respect to the money in an annuity as being “guaranteed,” as providing “lifetime income,” and being “nursing home safe,” none of which was true. Agents would also describe any surrender penalties involved in terms of a “free withdrawal” amount and not the full surrender charge.

The contracts drafted by American Investors Life facilitated this fraud. They violated a California senior notice which required annuities sold to seniors to disclose on the cover the location of the surrender information within the policy. They were also deceptive in that they obscured and hid through confusing policy language American Investors Life’s intention to apply surrender penalties, including applying a penalty on death.

Deceptive Annuity Contracts

Annuity companies assist these deceptive sales practices by making it difficult for purchasers, particularly seniors, to determine the risks they face when placing their money into what is an essentially illiquid investment. Although fixed, deferred annuities are a relatively simple investment vehicle, many insurers use complex language and confusing formats to disguise unattractive provisions, such as the amount of the surrender charges and the length of the surrender period. As an example, in *People v. Fremont Life Insurance Company*, *supra*, 104 Cal.App.4th at 512, the insurer made the amount of the surrender charge sound as if it was lower than it actually was by classifying part (5%) of it as a “premium charge” which was 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 clearly to describe the full economic consequences of early withdrawal of funds and was therefore likely to deceive.’” (*Id.*, 104 Cal.App.4th at 517-518.)

As set forth below, there are certain statutes which regulate the content of annuities sold to senior citizens. Two such

statutes, Insurance Code sections 10127.10 and 10127.13, require specific bolded language on the face page of the contracts regarding surrender penalties. Insurers regularly violate these statutes by failing to provide the required language.

Applicable Statutes

Because annuities are a form of insurance, they are subject to the Insurance Code.³ There are various provisions in the Insurance Code that are directed to senior annuity sales.

With respect to surrender penalties, 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....” These statutes were enacted at the request of the Department of Insurance precisely because seniors were often unaware of the surrender penalties they would face due to the unscrupulous sales tactics of selling agents and unclear contract forms.²

Insurance Code section 789.10 pertains to meetings at seniors’ homes for life and annuity sales. Agents are required to provide a prior written notice to the senior which discloses, among other things, that a sales presentation will be made for insurance products, that the senior has the right to have others present, and has the right to end the meeting. Agents are also required to disclose in writing that if a senior is going to sell or liquidate any investment to purchase an annuity that there may be tax consequences and that the senior may wish to seek independent legal or financial advice. (Ins. Code § 789.8(b).)

Overarching these specific statutes is Insurance Code section 785 which provides a statutory duty of honesty and good faith in the sale of insurance, with certain exceptions, to seniors. Thus, both sales agents and insurers must provide full disclosure at the point of sale of any annuity sold to any senior.

Continued Abuses

Despite the regulation that has occurred in this area, insurers and insurance agents continue to find ways to sell inappropriate annuities to senior citizens. For instance, during the housing boom, agents solicited seniors to take out reverse mortgages, then used this money to fund annuity purchases. A reverse mortgage is a long-term percentage loan on the equity of a home primarily made so that the borrower can increase their available cash flow and not have to pay the loan back until they die. A reverse mortgage is used to allow a borrower to live on the equity of their home at the direct expense of their heirs. While the reverse mortgage is outstanding, the loan accumulates interest that is added to the original amount of the loan, is compounded and is ever-growing. If plans are not made to pay back the loan, the accumulating interest over time will eventually raise the loan amount to a substantial portion, or all, of the equity of the home. Deferred annuities that carry substantial penalties which apply over a prolonged period of time for early withdrawals act as a barrier to a purchaser from having access to their funds and negate the basic purpose of a reverse mortgage. A reverse mortgage also carries various fees and costs which add to a senior’s growing debt.

Conclusion

Given the current turmoil in the financial markets, it is expected that insurers and their agents will find ways to gain access to seniors and use fear as a way to peddle annuities as safe investments. The insurers will continue to issue annuity contracts which obscure the significant risk of loss faced by senior purchasers, thereby facilitating the fraud committed at the point of sale by the agents. Rights and remedies available under the UCL and common law causes of action can be used to expose this fraud and provide meaningful relief for seniors. ■

¹ 2003 10-K filing of American Equity Investment Life Insurance Company.

² *Id.*

³ Insurance Code section 101.