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## Selecting Life Insurance Policies: Some Quick Tips

MALCOLM GREENHILL MBA, CFP

Estate planning attorneys who propose and draft life insurance trusts often find themselves discussing the selection of the policies that will be acquired by the trust. Indeed, it is occasionally suggested that attorneys who instigate such trusts may have due diligence obligations with respect to policy selection or the selection of a qualified consultant, particularly if they represent the trustee.

Although there is little consensus on the scope of such obligations in the absence of an agreement defining the practitioner's duties, a growing number of attorneys wish to improve their ability to help clients be critical consumers of life insurance products, and discussions of life insurance selection issues have become increasingly common in recent estate planning legal literature. See, e.g., Gallo, *Planning, Drafting, and Administering Irrevocable Life Insurance Trusts*, Estate Planning 1996, chap 10 (Cal CEB 1996). Further, the Insurance Planning Committee of the Real Property, Probate and Trust Law Section of the American Bar Association now maintains an Internet discussion group ("pt-insurance") devoted to this topic at <http://www.abanet.org/scripts/listcommands.bat/subscribe/pt-insurance>.

This article provides an introduction to selected problems frequently encountered in selecting policies. For the most part the discussion assumes that the client, with professional assistance, has already defined the purposes for which the insurance is being purchased and has determined the general types of policies that will address those needs.

### Insurance Company Ratings

From 1976 through 1991 approximately 290 domestic life and health insurers became insolvent or financially impaired. Although all states have state guaranty funds that pay the claims of insolvent life insurers, there are

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*MALCOLM GREENHILL* graduated (cum laude) from Essex University in England and received his MBA from Cranfield School of Management, and has an ABD from Balliol College, Oxford University. He is President of Sterling Futures Inc., a San Francisco fee-only financial advisory firm providing financial planning, investment management, and insurance counseling services. Greenhill is President of the San Francisco Society of the Institute of Certified Financial Planners and teaches a graduate course in Risk Management and Employee Benefits at Golden Gate University.

limits on the amounts guaranteed. Most state guaranty funds limit the maximum death benefit to \$300,000, while the cash value in life insurance and annuities is usually limited to a maximum of \$100,000. Although these funds pay death benefits promptly, policy owners may have to wait years before they can borrow or withdraw their cash values. Therefore, it is important to buy life insurance only from insurers that are financially sound. Ignore any intercompany comparisons prepared by insurance companies. Through a clever selection of measuring rods, every major insurer can produce a report that shows why it is "number one."

### Rating Organizations and Grading Systems

Five rating organizations periodically grade and rate life insurers on their financial strength (see Fig. 1). The companies are rated based on the amount of capital and surplus, legal reserves, quality of investments, past profitability, competency of management, and numerous other factors. Care must be used in considering ratings as rating organizations are not equally critical and their grading systems are confusingly inconsistent. For example, A.M. Best has a reputation for being an "easy grader," while Weiss Research is the most severe grader. One month before Mutual Benefit was taken

over by state regulators in New Jersey in 1991, A.M. Best gave the company an A+, which was its highest possible grade at that time. Standard & Poor's gave the same insurer a grade of A one month before it was considered insolvent, which was its sixth-highest grade on a scale of 17. In contrast, Weiss gave the company a grade of D+. The inconsistency in the meaning of the letter grades is also illustrated by the fact that a grade of A is the third-best grade from Best, while for Duff & Phelps and Standard & Poor's, a grade of A is the sixth-highest grade.

Taking account of these problems, Joseph Belth, emeritus professor of insurance at Indiana University and editor of the Insurance Forum, a newsletter that publishes annual financial strength ratings for about 1500 insurers, recommends that a company should receive a high rating from at least three of five rating agencies before a policy is purchased. For this purpose, the high ratings for each rating organization are:

- A.H. Best—the top two grades
- Duff & Phelps—the top three grades
- Moody's—the top four grades
- Standard & Poor's—the top three grades
- Weiss—the top six grades

Figure 1: Summary of Various Company Ratings

Rank	A.M. Best	Best's Description	D & P	Moody's	S & P	Weiss	Weiss's Description
1	A++	Superior	AAA	Aaa	AAA	A+	Excellent
2	A+	Superior	AA+	Aa1	AA+	A	Excellent
3	A	Excellent	AA	Aa2	AA	A-	Excellent
4	A-	Excellent	AA-	Aa3	AA-	B+	Good
5	B++	Very Good	A+	A1	A+	B	Good
6	B+	Very Good	A	A2	A	B-	Good
7	B	Good	A-	A3	A-	C+	Fair
8	B-	Good	BBB+	Baa1	BBB+	C	Fair
9	C++	Fair	BBB	Baa2	BBB	C-	Fair
10	C+	Fair	BBB-	Baa3	BBB-	D+	Weak
11	C	Marginal	BB+	Ba1	BB+	D	Weak
12	C-	Marginal	BB	Ba2	BB	D-	Weak
13	D	Below Min. Standards	BB-	Ba3	BB-	E+	Very Weak
14	E	Under State Supervision	B+	B1	B+	E	Very Weak
15	F	In Liquidation	B	B2	B	E-	Very Weak
16			B-	B3	B-	F	Under Supervision
17			CCC+	Caa	CCC		
18			CCC	Ca	R		
19			CCC-	C			
20			DD				

### **Keeping Ratings in Perspective**

One caution about relying too heavily on a company's ratings: Although ratings are important for helping the client to avoid obviously weak companies, ratings must be kept in perspective. The fact that a company is highly rated today is no guarantee that it will enjoy that same high rating a year from now. In fact, ratings often reflect past decisions made by past officers in past economic times in connection with past products.

Further, the fact that a company is highly rated at the moment does not ensure that any particular product of the company is among the best. A company may have a great whole life product but a mediocre second-to-die product.

### **Preserving the Ability To Change Companies Later**

Because of the inherent limitations of ratings, practitioners should consider strategies that increase the client's ability to change insurers at a later date without excessive financial loss. Unfortunately, the "loads" on most traditional policies can make such a switch costly during the first several years. According to the Life Insurance Marketing and Research Associates (LIMRA), the average load on a commissionable life insurance policy is 165 percent of the first year premium. Insurance companies will advance agent commissions and general agent overrides on completion of the sale and will recoup most of the load in the first few years. As a result, a commissionable policy often has little or no cash value for several years. Accordingly, practitioners should consider using low-load noncommissionable policies, with no cash surrender charge and a high immediate cash surrender value. These policies can be bought directly from the issuers or through insurance advisors who charge hourly fees instead of receiving commissions.

### **Selecting a Policy**

In comparing the products of different companies, the client or advisor will request "illustrations" of premiums, death benefits, and cash values from the insurance agent, showing both guaranteed and nonguaranteed performance. This dual performance level—minimum guarantees combined with an illustration of something better, usually based on current experience—is unique to life insurance and complicates the presentation and use of insurance illustrations.

### **General Illustration Problems**

Although policy illustrations are the basis of most sales of life insurance, they are much too often taken lit-

erally. A policy illustration is nothing more than a "what if" representation of a single set of assumptions which are then straight-line projected far into the future. The resulting numbers are almost impossible to duplicate in the "real world." The following are some practical tips for analyzing these insurance illustrations.

Always ask the agent for a full insurance illustration, complete with footnotes and a page or more of disclosures describing the underlying assumptions. This illustration should be three or more pages in length and show both guaranteed and nonguaranteed values. One-page illustrations are never complete and should not be accepted. For permanent cash value life insurance the projection of policy values and death benefits should extend well beyond life expectancy and at least to age 95. A 10- or 20-year projection for a 55-year-old is almost useless. Mortality costs often increase sharply after age 70 and policy cash values may decrease, causing the policy to lapse at later ages.

### **Consideration of Medical History**

If a client has a medical history, it is possible that he or she will be given a "table rating," which increases the "standard" premium by a given percentage. For example, a "Table A" rating might increase the premium by 25 percent while a "Table P" rating might increase it by as much as 500 percent. If a table rating is likely, it is best to review an illustration reflecting this additional premium rather than a "standard" policy. The client is then psychologically prepared to accept a rating when the policy is underwritten and will be pleasantly surprised if the policy is later issued with either a lower rating or no rating at all.

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***"Agents often use this 'bait and switch' technique to undermine the competition, knowing that prospects are rarely willing to repeat the ordeal of their medical examination and will reluctantly accept the higher rates finally offered to them."***

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Do not accept illustrations showing "preferred" or "super-select" ratings, as it is unlikely that older applicants will qualify for these rates. Agents often use this "bait and switch" technique to undermine the competition, knowing that prospects are rarely willing to repeat the ordeal of their medical examination and will reluctantly accept the higher rates finally offered to them.

If the client has an insurability problem, more comparison shopping is necessary. Certain companies are better than others for purposes of insuring persons with particular conditions such as heart disease or diabetes. It

should also be kept in mind that second-to-die policies may be available even if one of the insureds is uninsurable.

### **Universal Life Illustrations**

Universal life insurance is both flexible and transparent. Premiums are deposited into an accumulation account that earns a declared rate of interest, and mortality charges are deducted for the cost of the insurance. All credits and deductions are shown on an annual report to the policyholder. Premiums can be increased, decreased, or stopped altogether. However, the policy will lapse if the accumulation account balance cannot cover the cost of insurance and other charges. The death benefit can also be increased (subject to evidence of insurability) or decreased (subject to a required minimum). Cash values can be increased by depositing additional amounts or decreased by making withdrawals. So much flexibility can be a curse as well as a blessing. Universal life is easy to abuse because it lets you pay a low premium in anticipation of higher interest rates and lower mortality costs. If interest rates go down or the insurance charges go up, you may have to deposit more money into the policy than expected to prevent it lapsing.

There is a widely held myth that universal life has fewer guarantees than traditional whole life. This is not the case. Without exception, universal life policies have a guaranteed interest rate (typically 4 to 6 percent), a guaranteed cost of insurance (generally based on some version of the 1980 Commissioner's Standard Ordinary Mortality Table, which represents much higher mortality rates than would currently be expected for healthy individuals), and guaranteed maximum expenses. The difference between the two types of product is that universal life allows you to reduce the premium today, whereas traditional whole life makes you wait until the favorable experience actually occurs and can be passed along in dividends.

### **Surrender charges, interest rates, and mortality charges**

In analyzing a universal life product, three variables must be examined: surrender charges, interest rates, and mortality charges. Universal life illustrations often include two columns showing both accumulation and surrender values. The accumulation values are often higher than the surrender values, at least for the first ten years. The difference between the two columns is the surrender charge for that year. Clients will often point to the accumulation values as representing the values in their policy. However, on surrender it is only the surrender value, *i.e.*, the accumulation account less surrender charges, that is available to them.

The "current" or "assumed" interest or crediting rate should be compared with historical interest rates and the

investment yield of the company. If, for example, the current interest rate is 7.0 percent and the company's investment yield is 6.0 percent, then the reasonableness of the interest rate must be questioned. In any year, the current interest rate credited to the accumulation account of a policy should at least equal the rate the carrier is earning on its portfolio. Agents or advisors should be able to provide you with a history of interest crediting rates and portfolio yield. It is important to run illustrations both at current rates and at a more conservative rate of, say, 1 percent below the current rate, to allow for a downward movement in interest rates.

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***"This tactic dramatically lowers the cost element of the projection (not the actual policy cost) and produces highly inflated values."***

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Mortality charges, like interest rates, are illustrated at "current" and "guaranteed" rates. It is important to compare these rates in any given product to measure the possible disadvantage if current mortality charges were to increase. It is also important to find out if the illustration is assuming a "mortality improvement," that is, a projected improvement in mortality rates over current rates. In 22 of the last 27 years, mortality expense has decreased; in five of the last seven years, however, there has been no improvement. Yet some companies assume that this "trend" will continue, and project a decreasing mortality expense! This tactic dramatically lowers the cost element of the projection (not the actual policy cost) and produces highly inflated values.

### **Persistency bonuses**

In the early 1980s, universal life sales were swept along by high interest rates and many companies rushed to develop "interest sensitive" products. Consumers have since learned that interest rates can go down as well as up, and companies have learned that it's hard to design a universal life product that is both competitive and profitable. To restore excitement and profitability to the product, some companies have introduced persistency bonuses. Also called policy enhancements, persistency bonuses are intended to give policyholders an incentive to keep their contracts in force. These incentives include:

- Declaring a retroactively higher interest rate after some period, usually at least ten years;
- Declaring an interest-rate bonus after some period or after cash values exceed a certain amount (*e.g.*, paying an extra 0.5 percent if cash values exceed \$10,000);
- Declaring a premium bonus after some period (*e.g.*, adding 45 percent of the scheduled premium to the

- cash value each year, starting ten years from issue); and
- Refunding a portion of the insurance charges after some period (e.g., every ten years).

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***“In most industries this would be called fraud. Journalists would expose it and the victims would sue. In the life insurance industry, however, it’s simply called a ‘current illustration practice.’”***

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Persistency bonuses have added a new level of complexity to policy comparisons. Some bonuses are legitimate ways of rewarding policyholders who make regular premium payments or who simply keep their contracts in force. Lower lapse rates and more money under management can generate enough additional profits to finance the bonus. In contrast, some bonuses are merely lures, with little chance of actually materializing. The company uses them to attract sales but is not really committed to paying them. In most industries this would be called fraud. Journalists would expose it and the victims would sue. In the life insurance industry, however, it’s simply called a “current illustration practice.” There is always a footnote at the end of the ledger statement that says something like “Illustrated values are not guaranteed”—and that’s what the company will point to if you try to take them to court. Finally, some bonuses are tontines, an arrangement in which surviving policyholders benefit at the expense of those policyholders who die or let their policies lapse. Dropouts receive less than they normally would, and these funds are used to finance the bonuses for those who remain. Consequently, when a universal life policy has a persistency bonus, you may be looking at an equitably priced product, an instance of fraud, or a tontine.

#### ***Whole Life Illustrations; Vanishing Premium Problems***

Under a whole life policy the annual premium is fixed and, as long as the premium is paid, the death benefit and a certain level of cash value are guaranteed. However, whole life illustrations usually show a vanished premium in 7 to 12 years, that is to say, premiums are paid for the illustrated period and thereafter no further premiums are required. Once premium payments stop, dividends are used to offset the out-of-pocket premium outlays and the dividend scale is not guaranteed.

If dividend projections are not met, the number of premium payments may have to be increased. It must also be emphasized that cash values are guaranteed only if premiums are paid every year. On a “vanish” illustra-

tion, cash values will not be guaranteed once annual premium payments stop. Most whole life illustrations show guaranteed cash values extending past the last premium payment on a vanish illustration and only a careful reading of the footnotes makes it clear that these values will materialize only if premium payments are made every year for life or if future dividends are sufficient to pay these premiums.

#### ***Understanding Second-To-Die Illustrations***

##### **Term riders**

This policy typically insures a husband and wife. The death benefit is paid on the second death and is used to fund the estate tax liability deferred by the marital deduction. Survivorship whole life or survivorship universal life is often combined with a term rider. The maximum amount of term insurance rider can vary from 25 percent to 75 percent of the total death benefit, depending on the product and the age of the insureds. The term rider carries no cash value and lowers the overall premium. In a whole life policy with a term rider, policy dividends pay the term insurance and may purchase paid-up additional whole life insurance, which gradually replaces the term insurance.

Second-to-die policies are subject to the same variables of mortality, interest, and expenses as whole life and universal life policies, but the term rider adds an additional element of risk. The second-to-die insurance illustration projects premium payments, cash values, and death benefits based on current term insurance rates. These rates may be guaranteed for one to three years, but usually not longer. In fact, the guaranteed term rates are often two to three times the current term rates, which significantly increases the risk that higher premiums will be required at a future date. The term rates increase with age, and may change at the first death from the “joint life” mortality rate to the higher “single life” mortality rate, depending on the type of product. To evaluate the risk, the illustration should demonstrate both the effects of death of one of the two spouses and a reduction in the dividend interest rate or crediting interest rate of one to two points. The client can then be informed about the possibility of an increase in the number or amount of premiums in the future. To minimize risk, it is advisable to avoid using a term rider or to use only a relatively small amount (less than 20 percent of the total death benefit).

##### **Policy splitting rights**

It is also important to use second-to-die policies that can be split into two individual policies without evidence of insurability or financial need if changed circumstances or changed tax laws make that desirable. If there is a charge for this option it must be included in all

quotes. When a policy is split, the two new policies should not have acquisition costs, such as new commissions, or additional loaded mortality charges.

### **Variable Life Illustrations**

A variable life policy can take any of the forms of permanent life insurance described above. Variable life is distinguished by having cash values backed by funds in separate accounts (*i.e.*, special investment portfolios similar to mutual funds that are segregated from the carrier's general account). The policyholder has a number of different funds from which to choose. Insurers may invest some of their separate account funds in assets with a higher degree of volatility and risk than the typical general account portfolio. All the investment risks for these funds, including the risk of loss of principal, are passed directly through to the policyholder.

When examining a variable life policy illustration, study what happens to policy values at different rates of return, say, 0 percent, 5 percent, 8 percent, and 10 percent. A small difference in return can make a big difference in policy values, death benefit, and the length of time the insurance stays in force. Other things unchanged, if cash values are higher than expected due to increased rates of return, more money is available to extend the length of time the insurance is in force, to purchase additional amounts of insurance, or simply to provide a greater cushion against lower rates of return in future years. Presenting a variable life illustration at anything over 10 percent is aggressive.

The difference between the gross and the net return on the investment choices is the investment advisor fee and fund operating expenses. This can be as much as 2 percent a year. Check in the prospectus to see the expense ratios of each fund. Historically, insurance companies have not been the best equity managers. The prospectus will disclose whether the insurer has hired outside money managers and, if so, at what cost. Remember, variable life insurance is so named because, of all insurance products, the account values are subject to the greatest variability. Although some variable whole life products guarantee a minimum death benefit for life, a prolonged economic downturn affecting stock prices will have a significant effect on the plan of insurance. Before using variable life insurance, you should consider both your client's risk tolerance and the problem the life insurance was designed to solve. While variable life insurance can provide a hedge against inflation, your client's problem may be too important to risk the solution on the vagaries of the stock market.

Finally, variable insurance offers a degree of additional protection against carrier insolvency problems. If an insurance company becomes insolvent, all general account assets back the liabilities of all general account products, as well as the claims of creditors. However,

the assets of the separate accounts in a variable contract cannot be used to satisfy the general account obligations. This separate account protection applies to cash values, ensuring that they will be accessible on a timely basis, even for amounts in excess of the state guarantee fund limits. Because the portion of the death benefit payment in excess of the cash value is payable from general account assets, however, in a troubled company variable insurance does not ensure the payment of this excess any more than would a general account product.

### **Premiums and Risk Tolerance**

When using illustrations to evaluate policies, consumers should not simply line up the illustrations side by side and pick the one with the best projected numbers. Illustrations are best used to understand how a specific policy works under assumptions imposed by the client and advisor (premium timing and flow; cash value loans taken and then repaid; interest crediting rates or dividend scales rising, falling, and resting). For example, you can ask the agent or advisor to run illustrations based on higher or lower interest rates and higher or lower mortality costs and then examine the effect this has on premiums, cash values, and the length of time the insurance remains in force. Other things equal, a lower interest crediting rate and/or a higher mortality rate will necessitate a higher premium to maintain the same plan of insurance. The concept of a range of different premiums should be communicated to clients so that they can make an educated choice as to the premium level.

The lower the premium, the more sensitive the policy will be to "swings" in interest and mortality rates. Despite the natural tendency of most clients to gravitate to the products with the lowest premiums, higher premiums can be desirable in order to avoid these swings and to make it more likely that the policy can be sustained during unfavorable times. Higher funding also increases the possibility that the policy will perform better than predicted if there are periods of high investment return.

### **More Information**

The American Society of CLU & ChFC (1-800-392-6900) has developed the Life Insurance Illustration Questionnaire (IQ), a set of 27 questions designed to help agents and consumers understand the different nonguaranteed performance assumptions that insurance companies use to design and create sales illustrations. Blank questionnaires as well as a list of the companies that have completed the IQ can be obtained directly from the American Society of CLU & ChFC. Insurance carriers or agents must be contacted directly to obtain responses to the IQ questionnaire. To date, approximately 100 companies have sent in their responses to the IQ.

When evaluating proposals, the author also typically asks the agent or company concerned to complete the risk disclosure form that appears below, which is de-

signed to identify the nonguaranteed assumptions underlying the ledger illustration in substantially less detail than the IQ questionnaire.

**RISK DISCLOSURE INFORMATION IN THE CASE OF**

Name of Client \_\_\_\_\_ Life Insurance Company \_\_\_\_\_

The following information relative to the attached illustrated proposal for insurance is true and correct:

- (a) The current interest rate/dividend scale is \_\_\_\_%.
- (b) The company's net portfolio yield is \_\_\_\_%.
- (c) The projected interest rate or dividend scale used in this illustration for the first year is \_\_\_\_%.

A noncontractual change is illustrated in year \_\_\_\_\_ to \_\_\_\_\_%.

A noncontractual change is illustrated in year \_\_\_\_\_ to \_\_\_\_\_%.

Other changes occur in \_\_\_\_\_.

- (d) Term riders consist of \_\_\_\_\_% of the face amount (if whole life/term blend).
- (e) A bonus on cash values is credited in year \_\_\_\_\_.
- (f) A maturity or termination dividend is credited in year \_\_\_\_\_.
- (g) Are illustration mortality assumptions different than current experience? \_\_\_\_.  
If so, when do those differences occur? \_\_\_\_\_.
- (h) Are there surrender charges? Yes No. If so, \_\_\_\_\_% for \_\_\_\_\_ years; or  
Other: \_\_\_\_\_.
- (i) Compensation paid by the insurance company, as a percentage of policy premium is as follows:

	First Year	2nd Through 5th year	Remaining Years
selling agent	____ %	____ %	____ %
general agent	____ %	____ %	____ %

- (j) Compensation paid outside the policy. \_\_\_\_\_.

\_\_\_\_\_  
Insurance Company Representative, Title

\_\_\_\_\_  
Date

\_\_\_\_\_  
Signature

\_\_\_\_\_  
Date



### Sources of Company Rating Information

The simplest way to obtain current ratings and rating reports for a company being considered is often to request copies from the agent or advisor representing that company. This information can also be obtained directly from the rating services on a single company or on a regular subscription basis.

A.M. Best Company  
Ambest Road  
Oldwick, NJ 08858  
908/439-2200

Also, many public libraries carry Best's Insurance Reports: Life-Health. This book, usually published in the fall, contains Best's full reports on all rated companies.

Duff & Phelps Credit Rating Co.  
55 East Monroe Street  
Chicago, IL 60603  
312/368-3157

Moody's Investors Service  
99 Church Street  
New York, NY 10007  
212/553-1653

Standard & Poor's Insurance Rating Services  
25 Broadway  
New York,  
NY 10004  
212/208-1146

Weiss Research, Inc.  
P.O. Box 109665  
Palm Beach Gardens  
FL 33410  
800/289-9222