

Life Insurance: When The Vanishing Premium Reappears

Malesovas, Martin & Tekell, L.L.P.

Tekell, David G.

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I. INTRODUCTION

"Vanishing premium" life insurance sales illustrations may have been all the rage in the life insurance industry in the 1980's, but when those premiums began to reappear in the 1990's, the life insurance industry was faced with a crisis in confidence--and a rash of policyholder suits--which has shaken its very foundation. Recent articles in the financial press have chronicled the verdicts and settlements that have resulted, and now the attention of the Bar has been captured. ⁽¹⁾

Over the past few years, quite a bit of case law has developed on "vanishing premium" insurance litigation. Many state governments have reacted by adopting regulations restricting the use of "vanishing premium" sales illustrations. The insurance industry has also reacted by settling the claims of millions of policyholders defrauded by the "vanishing premium" sales scheme. ⁽²⁾ The subject of "vanishing premium" litigation, however, presents a number of factual and legal issues that are difficult to understand without some background in life insurance concepts. For this reason, the first part of this article covers some basic life insurance concepts related to the "vanishing premium" sales strategy. After that, there is an explanation of the more common "vanishing premium" sales strategies and their potential abuses. Finally, there is a brief discussion of the legal strategies being used to prosecute claims against the companies and agents who have committed one or more of these abuses.

II. OVERVIEW OF "VANISHING PREMIUM" BASICS

A. The Basics of Life Insurance Products

1. Traditional Life Insurance Products

Life insurance policies or "products" are as varied as the companies who sell them. The basic plan of insurance underlying each product, however, can be fit into one of the following categories.

(1) **TERM POLICIES** are life insurance policies limited to a stated period or "term" during which the insurance company will provide coverage. The "term" is usually from one to ten years. If you want the insurance to continue after the "term" is over, you have to requalify (prove you are healthy), and the company will set a new, usually higher, premium. "Level term," "decreasing term," "increasing term," "renewable term," and "convertible term," are all variations of this basic product. Although "vanishing premium" sales tactics have not been used with term plans, the basic concept of term insurance underlies all other policies. At the core of any insurance product is the determination of an amount of money - the mortality charge - that the insurance company charges in exchange for its agreement to pay the stated death benefit if the insured dies within the time frame or "term" set. The cost of term insurance is basically this mortality charge plus an amount for the company's profit.

(2) **WHOLE LIFE POLICIES** are products that can be kept in force for the insured's entire or "whole" lifetime. The insured does not have to requalify periodically, and the company cannot rescind the policy (for reasons such as declining health) as long as the premiums are timely paid. Whole life products also have a savings component. After the first few years of premiums have been paid, a whole life policy starts to build up its cash surrender value--the amount of money the company will pay the insured to

cancel or "surrender" the policy. This amount goes up every year and is determined by a complex mathematical formula. Generally, however, its value is dependent upon (a) the company's guaranteed interest rate factor (usually conservatively set anywhere between 3% to 7%), and (b) the difference between the premium paid and the company's actual cost for term insurance for that year. The premiums on whole life insurance are usually the same each year ("level"), and in the early years of the policy, usually much larger than the cost of a corresponding amount of term insurance. This extra cushion of money above the mortality charge gives the company something to return to the policyholder upon cancellation or something to invest if she does not cancel, usually called a dividend. The guaranteed interest rate used in calculating the cash surrender value is generally 3 to 4 percentage points lower than what the company expects to earn on this money by investing it in the market.

Most whole life products are "continuous level premium" policies: a premium of a stated amount must be paid each year (or perhaps until a very old age, such as age 95). There are, however, plans specifically designed to be "limited payment" policies which contractually guarantee the policy will be in force through the insured's "whole life" if the insured pays the stated premiums through the age or year specifically set out in the policy. ⁽³⁾

Whole life policies can be either PARTICIPATING or NON-PARTICIPATING. With a "participating" whole life policy, the insurance company offers an additional investment component (separate and apart from the increase in guaranteed cash surrender value) in the form of a dividend. Dividends are not guaranteed and are tied to the company's profitability. In theory, the insured participates with the company in the profits made by the company with the insured's premium dollars. Non-participating policies that do not pay dividends are usually priced lower and may use lower assumptions for mortality and expenses.

(3) UNIVERSAL LIFE INSURANCE POLICIES were introduced into the marketplace starting in the early 1980s. This policy is an attempt to "unbundle" the cost and savings components of the policy so that the insured can monitor each of them separately and compare the performance of the company's policy with policies offered by other companies. The cost of the actual insurance--the mortality charge--has a guaranteed maximum rate. This maximum rate is conservatively set so that the company would not lose money if mortality experience in the future caused the company to have to charge at the maximum guaranteed rate. Likewise, the amount of the premium dollars paid into the policy over and above the policy's mortality charge (after the payment of certain stated expenses) earns interest at a variable rate of return. The policy itself will state the minimum rate of return that the company guarantees to pay. Usually this amount is also conservatively set, and the actual or "declared" rate of return will be higher. The insured has the ability to "overpay" premium into the policy so that he takes advantage of the tax-free interest paid on the excess.

(4) VARIABLE LIFE POLICIES are an even more recent entry into the market. They take the universal life concept one step further and tie the rate of return earned on the policy's savings component to an investment plan chosen by the policyholder. The policyholder may choose conservative investments such as U.S. Treasury Bills, predictably and safely earning 4% to 5% annually, or may choose something aggressive, like a growth stock fund, which may pay double-digit returns or may lose money. Variable life policies were not prevalent in the mid-1980's when the "vanishing premium" sales craze was abounding. Because of securities regulations, prospectuses are required to accompany the sales presentation materials and projections of future earnings are not allowed. It remains to be seen whether variable life policy sales will produce the market conduct liability cases similar to the vanishing premium cases.

2. Standard Non-Forfeiture Benefits

In the early days of the life insurance industry, when a policyholder stopped paying on a whole life policy and it lapsed, the policyholder got nothing in return. Insurance companies got rich, but the industry's image suffered. By the early 1950's, each state had passed a version of the Standard Non-Forfeiture Law requiring that a cash surrender value be provided if the policyholder decided not to keep the policy for its full term or for his "whole" life. In addition to the guaranteed cash surrender value, determined by a complex formula and the company's guaranteed interest rate, the Standard Non-Forfeiture Law also requires that insurance companies give the option of reduced paid-up insurance. "Reduced paid-up insurance" is the amount of insurance (maintained for the remainder of the policy's original term) which the company will allow without any further premium payment. The death benefits of reduced paid-up life insurance are usually a small fraction of the original face amount of the policy.

3. Dividends/Non-Guaranteed Returns⁽⁴⁾

The underlying foundation of any "vanishing premium" sales illustration is the non-guaranteed increase in policy value--the dividend for whole life policies or the interest rate for universal life policies. Because most "vanishing premium" litigation to date has involved whole life policies, this discussion will focus on understanding the dividend, its function in the "vanishing premium" illustration, and the factors (rarely, if ever, fully disclosed) which cause it to fluctuate considerably.

With respect to Participating Whole Life Policies which pay dividends, the company develops a set of assumptions for its dividend called the "dividend scales." Although dividends are "not guaranteed," the fact is that "participating" companies have consistently paid dividends every year for most of this century. Because of competition between insurance companies, a company's dividends payout is closely watched by its competitors. The failure to pay a dividend would be viewed in the marketplace as nothing short of a disaster. Accordingly, companies historically developed their dividend-producing whole life products with conservative assumptions which will allow, even in less than spectacular years, the payment of a dividend to the policyholder at the end of the policy year.⁽⁵⁾ Although each company develops its own proprietary dividend formula which it uses to calculate the dividend payable on a particular policy for that year fairly and without discrimination, the basic structure of the dividend formula uniformly follows the basic pricing assumptions of life insurance.⁽⁶⁾

There are four basic assumptions in the pricing of life insurance policies: (1) mortality, the rate at which people die and claims must be paid by the company for death benefits, (2) expenses, the administrative costs of selling insurance (commissions) and of running an insurance company (administrative), (3) persistency or lapse rate, a factor which accounts for the policyholders who discontinue the policy for whatever reason, and (4) investment earnings, the rate of return the insurance company can make by investing its cash reserves in the marketplace. Actuaries make their living developing complicated mathematical formulas to express these assumptions when a policy is originally developed, comparing those assumptions with actual experience in later policy years, and modifying those assumptions as necessary and as permitted to express the company's actual experience. It is not as important to understand what these mathematical formulas might be as it is to understand that they are often poor predictors of future experience and are modified as actual experience replaces predicted experience. These changes will result in changes to the dividend scales as dividend projections are replaced with dividends actually paid out.

Dividends will be higher or lower than these projections, depending on whether the actuarial formulas proved to be too conservative or too optimistic. For instance, if the actuaries pricing a whole life policy were to project mortality expenses at one level, and actual experience proved mortality expenses to be at a lower level, the company would have made more money on that policy than it originally expected. Likewise, if the actuaries assumed investment earnings rates at an overly optimistic rate, and actual

experience was that those rates were lower, the company would not have made as much money as it had expected on the policy. The result is that illustrated performance cannot be met unless the company is willing to earn less or even take a loss on the policy.

Before products are originally introduced, the actuaries make an educated guess as to what the dividend scale on those policies will be when dividends are actually paid in future years.⁽⁷⁾ Companies are restrained by little more than actuarial principles - and are often more motivated by marketing concerns - when formulating dividend scales for newly introduced products. In fact, a common practice in the industry is to reverse-engineer its product by analyzing illustration software obtained from competitors. The thought is that agents in the field will pick the product with the better illustrated performance, so beating a competitor's illustrations is seen as the primary task of a pricing actuary. Obviously, this competitive pressure can end in a company "fudging" some of its assumptions to come up with a competitive product - a race to the bottom as insurance companies change their assumptions to sell more product. Because of the lag time between a policy's development and the time when dividends are actually paid on that policy, even the company's first dividend scale may be significantly different from the dividend scale assumed when the product was initially priced.

Although dividend formulas are closely guarded secrets,⁽⁸⁾ that formula is necessarily an expression of the four basic assumptions regarding mortality, expenses, lapse and earnings used in the pricing of insurance products generally. As detailed below, missing the mark in the 1980's on these assumptions--primarily investment earnings, but also persistency and expenses--caused great consternation for policyholders as well as the industry itself in the 1990's.⁽⁹⁾

4. Dividend Options

A standard provision for participating policies is the provision governing the dividend option. The policyholder will be given the choice of one of several ways of handling the dividend paid by the company. One option is to take the dividend in cash. Another option is to leave the dividend on deposit with the company where it will earn interest at the company's announced rate. A third option is to apply the dividend to reduce premiums so that the net out-of-pocket amount paid as a premium by the policyholder is reduced or eliminated. A fourth option is to use the dividend to purchase paid-up additions--additional amounts of insurance which will (a) add to the death benefit payable, (b) have their own cash surrender value, and (c) generate their own dividends. As explained more fully below, the proper strategic use of this dividend option by the policyholder at appropriate times is critical to many "vanishing premium" illustrations.

5. Policy Loans

Another standard provision of most traditional life insurance policies which has come into play with the "vanishing premium" sales illustrations is the policy loan provision. When the policy's cash surrender values have been built up from several years of paying premiums, most policies allow the insured to borrow money from the company using the built-up cash surrender value as collateral. The policyholder is charged interest on this loan at a rate determined by the policy. That rate can either be fixed or variable from year to year. Most policies also have an automatic premium loan provision which, if selected, allows the company to loan the policyholder an amount sufficient to pay any premium not paid in cash by the policyholder when due. Through this provision, the policyholder avoids a lapse of the policy due to inadvertence or inability to make a premium payment. This option is usually "selected" by the insurance agent for the policyholder when the original application is completed.⁽¹⁰⁾

B. Historic Performance of Life Insurance Products

In order to understand the "vanishing premium" crisis of the 1990's, one must go back to its historic context. For the life insurance industry, the first seven decades of this century were marked by consistency and predictability. The life insurance industry, through the advent of medical and scientific advances, got the benefit of steadily improving mortality experience. Likewise, for the most part, conservative investing practices produced steady and predictable investment earnings. Because of a gradual increase in investment rates of return during the 1960's and 1970's, life insurance company's investment earnings exceeded the conservative projections built into both the pricing of their products and dividend scales implemented during the previous decades. Many North American companies built up track records where they could accurately boast that they had always met or exceeded dividend and/or interest rate projections throughout their company's entire history. By doing so, they built up expectations, in both their policyholders and agents, that they could always be counted on to meet or exceed their dividend or interest rate projections in the future. Thus, while these dividends were not contractually guaranteed, the highly-touted history of the company gave, in essence, a de facto guarantee that dividend and interest rate projections would always be met or exceeded. While illustrations continued to carry the standard disclaimer that dividends were not guaranteed, because of the companies' track records, these caveats were largely ignored by both agents and policyholders alike. Because it was assumed it would never happen, very little thought was given, at least at the consumer end of the process, to what might happen to policy values if dividends or interest were not paid as projected. In fact, many agents stressed that performance could actually be better - and premiums would vanish even earlier - rather than dwelling on the non-guaranteed nature of dividends and interest rates or illustrating a worst case scenario.

C. The Illustration of Life Insurance Policies and Their Future Values

To say that an insurance policy paid "dividends" and to say that the company had always exceeded its "dividend projections" was one thing; however, nothing could bring this concept to life more graphically than the matrix of numbers known as the illustration. The evolution of the illustration from simple printed forms to highly customized, computer-generated charts is likewise blamed for the "vanishing premium" crisis of the 1990's.

1. Before Computers--When Life Was Simple

Before the prevalence of computers, an actuary would have to sit down with a slide rule or calculator and model policy values for a hypothetical policyholder at a common age for a common amount of insurance (i.e., male, age 35, nonsmoker, \$100,000 death benefit). He would then generate a chart of future values by hand using the cumbersome formulas for the policy's pricing assumptions and current dividend scale. These charts would then be printed and reproduced for use in the field by an agent and policyholder who would be left to extrapolate from that chart what might be expected in their particular circumstances. Estimation was necessarily involved in this process.

2. The Computer Age Comes to Life

With the advent of computers, however, these mathematical formulas could be programmed and the computer would then generate the sample illustration. The computer equipment (both hardware and software) was, at first, maintained exclusively in the home offices of the companies who developed them. While more standard sample illustrations might be available, a customized illustration meeting the prospective policyholder's specific needs might take weeks to get from the company's home office.

This changed, however, around 1982 when personal computers began to appear in agents' offices. By 1985, most agents were armed with a PC and the latest version of the company's illustration software

from which truly customized illustrations could be created instantaneously.⁽¹¹⁾ Life insurance sales soon degenerated into competitions between illustrations; and, realizing this, the most competitive companies spared no expense at developing and updating their computer illustration systems (along with their actuarial assumptions) to produce the best illustrations.

3. Regulation of Illustrations

In regulations adopted by the Texas Department of Insurance in 1998, computer-generated illustrations are now independently regulated under 28 T.A.C. §§ 21.2201-21.2214, which apply to all policies sold after July 1, 2000. This subchapter in the Texas Administrative Code follows Model Regulation No. 582 on Life Insurance Illustrations promulgated by the National Association of Insurance Commissioners in 1995. Generally, these regulations govern the way an insurance company can illustrate the non-guaranteed performance of its policies, including specific rules dealing with the illustration of interest-sensitive and lapse-supported policies.

During the boom-time in "vanishing premium" sales, however, there were no similar restrictions on illustrated dividends, so computer-generated illustrations based upon non-guaranteed dividends and other non-guaranteed policy values, which completely omitted more conservative guaranteed values and elements, became the norm in the illustration competition between companies. At that time, as is still the case, illustrations were treated by the code as any other advertisement used to sell life insurance policies. As with most states, the Texas regulations required that an advertisement not utilize or describe dividends in a manner that is misleading or has the capacity or tendency to mislead and an advertisement must not state or imply that the payment or amount of dividends is guaranteed. 28 T.A.C. § 21.114(6) (A)-(B). Further, the regulations required that any illustration of interest rate projections must be illustrated alongside, and with no greater emphasis than, projections based upon guaranteed rates. 28 T.A.C. § 21.114(4)(G). Compared to the illustration rules later adopted by the Department of Insurance, the regulations during the time of most vanishing-premium sales were anemic at best.

D. The Eighties: Greed Replaces Need as the Basis for Life Insurance Sales

In contrast to the relative stability of the seven decades which preceded them, the 1980's ushered in a host of conditions that had never before been experienced by the life insurance industry. In the financial marketplace, double digit interest rates became commonplace. The eroding effect of double digit inflation coupled with the competitive draw of double digit rates of return through other investments caused policyholders to take a long, hard look at the built-up cash values in their life insurance policies that were earning low rates of return and were diminishing in real value. "Buy term and invest the difference" became the competitive cry of the financial services industry. Faced with the prospect of losing policyholder premium dollars as well as the cash surrender of older policies, the life insurance industry had to change its products in order to continue to sell policies.

To compete, the industry started offering interest-sensitive policies designed with values that kept pace with inflation and with the financial marketplace. The industry lobbied for and received permission to sell policies with variable loan rates for the first time in 1983.⁽¹²⁾ These new products, built upon more aggressive interest rates and other assumptions (and thus having higher policy values) became the answer to competition from the financial services industry.⁽¹³⁾ On this new playing field, computer-generated illustrations became the life insurance agent's most valuable piece of equipment.

With dividends based upon double digit interest rates, and guaranteed policy values based upon now more optimistic interest rates, these computer-generated illustrations could show huge, mind-boggling numbers (in the non-guaranteed columns, of course) projected 20, 30, 40 or even 50 years into the

future. Of course, it did not take long for someone to realize these policy value build-ups could be put to good use to solve one of the most common gripes about life insurance: "I have to keep paying for it until I die, even after I retire, or else I lose it." Although the "vanishing premium" sales tactic was not new, these new illustrations and the rosy future values these interest-sensitive products could project were now graphically illustrating how the "policy would pay for itself" after so many years. The concept became immensely popular, and the agents demanded that their companies continue to develop more powerful software to show various ways premiums would "vanish."⁽¹⁴⁾

The "vanishing premium" sale was thus seen as a "win-win-win" situation: the company won by booking sales at astronomical rates never before experienced, the agent won by earning immediate commissions on higher-priced, whole life policies, and the policyholder won by taking care of his life insurance needs through a budgeted amount of payments certain to end before retirement.

E. How "Vanishing Premium" Illustrations Work

The theory behind a "vanishing premium" sales illustration is fairly simple: because dividends (or other non-guaranteed returns) are projected to increase substantially each year of the policy's life, at some point in the future, those dividends can be projected to equal or exceed the premium. Thus, when this vanish year is reached, the policyholder can simply direct that the dividend received at the end of the previous year be applied to pay the premium for the current year. Simply put, (and it was often very simply put by the agent) the policy thereafter pays for itself!

Of course, several key assumptions have to come true in order for the "vanishing premium" strategy to work as illustrated. The fundamental flaw with the vanishing premium strategy is that these assumptions were not likely to hold true. In fact, the assumptions were often so outrageous, the companies themselves could not have possibly expected them to hold true.

1. First Assumption: The Dividend Scale Remains Constant

Although new regulations may change this, insurance regulation in almost every state historically required that, when dividends were illustrated, they be illustrated based upon the company's current scale. However, because companies expect to change their dividend scales periodically, on average every one or two years, any change in the dividend scale will change the amount of dividends paid in the current year as well as the amount projected to be paid in future years. Thus, the "vanishing premium" illustration, as well as any other illustration of values projected any more than a couple of years into the future, will be made obsolete by this periodic changing of the dividend scales. Even so, the typical "vanishing premium" illustration assumed that the dividend scale would remain constant for every future year illustrated, even those 30, 40, or 50 years out.

2. Second Assumption: The Company's Investment Rate of Return (Dividend Credit or Interest Rate) Will Remain Constant

One of the main components of a dividend scale is an interest rate factor for the company's earnings on its investments.⁽¹⁵⁾ To set the "current scale," only one interest rate is used by most companies. This dividend credit rate or dividend interest rate will be assumed to be the same for dividends calculated in year 5 of the policy as it will be for dividends calculated in, say, year 55 of the policy.

3. Third Assumption: This Investment Rate of Return (Interest Rate) Will Be Relatively High

With the high rates of return that were available in the early 1980's, actuaries would justify using a high

dividend interest rate when setting "current" dividend scales, at least for the short term. "Vanishing premium" illustrations were built upon the assumption that the historically high interest rates of that period would continue for each and every future year, 50 or 60 years into the future! While many policyholders may have understood that their policies were interest-sensitive, companies and their agents rarely, if ever, made any attempt to show the guaranteed performance of their policies, or to explain how the company arrived at the interest rates it declared on its products. Consequently, consumers who expected their policies to perform as the market performed were greatly surprised when their interest-sensitive policies performed *worse than the market*. Some of this effect, in fact, might be explained by the company's changing of its interest rates for reasons other than changes in what it was earning on its investments. For example, the company might lower its credited interest rate to make up for an improper lapse assumption or to recoup for other wrong assumptions made when it originally priced the product. Few consumers, if any, know about these risks.

4. Fourth Assumption: The Dividends in Later Years Will Be Much Higher

Although "vanishing premium" illustrations can be made with dividend scales using low dividend interest rates, the "vanish year" will be much further out into the future. As both the companies and agents knew, no 55-year-old man would be interested in a policy whose premium is projected to vanish when he is 85 years old. The magic of compounded interest allowed the companies to project higher and higher dividends each year, and thus vanish years in the single digits. By projecting higher and higher dividends paid in future years in these "vanishing premium" illustrations, the dividend scales could be charted on a steadily steepening curve so that the dividend projected to be paid in, say, year 11, would be commensurably higher than the dividend paid at the end of year 10. No law or regulation required the company to pay dividends in this manner. In fact, the company was constrained only by actuarial principles (to the extent that it felt constrained at all) and competitive forces within the marketplace to pay dividends this way.⁽¹⁶⁾ As with any compound interest scenario, a small change in the initial interest rate meant a huge change in the projected build-up in future years.

F. "Super Vanish" and Other Augmented Vanish Strategies

The vanish strategy described above (where premiums are projected to be paid straight out of dividends) is commonly referred to as a "straight vanish" or "regular vanish." The vanish year in such cases is simply the year when the dividend is projected to equal or exceed the premium. However, there are other policy benefits and options which could be used to supplement or augment the straight vanish strategy so that the policyholder could stop paying premiums out of his pocket considerably sooner.

1. Super Vanish Strategy

As we have seen, one of the standard terms of a whole life participating policy is the loan provision. As soon as there is enough cash value in the policy, the policyholder can take out a loan against the cash value and use it for payment of the next year's premium. As long as there is sufficient cash value in the policy to secure the loan, the policyholder never has to pay the loan back. If there is a loan outstanding at the death of the insured, the loan is simply taken out of the death benefit proceeds.

The same software that is programmed to create the "vanishing premium" sales illustrations can also be programmed to solve for the optimum points at which policy loans can be taken out to pay the next year's premium without decreasing the net death benefit below the face amount of the policy. The illustration strategy commonly known as the "super vanish" or "loan vanish" illustration calculates that point and assumes that the policyholder uses these loans to pay premiums until the dividend gets large enough to take over paying those premiums. Thus, while a "straight vanish" might not be projected to

occur until the policy has been in force for 10 years, a "super vanish" illustration will show how the policyholder can stop paying premiums out-of-pocket (and use loans until the dividends take over) as early as year 4 or year 5.

Such "super vanish" illustrations may in fact rely upon an internal arbitrage. An arbitrage situation occurs when the variable policy loan rate is less than the dividend interest rate. For example, the company can loan you money at, say, 9%, and allow you to invest that money in a vehicle which is earning, perhaps, 11% or 12%. This arbitrage can occur because variable loan rates will automatically change as market interest rates go down whereas the dividend interest rate will only change every two years or so. ⁽¹⁷⁾

2. Paid-Up Additions Purchase/Surrender

Another augmenting strategy is to choose the dividend option so that dividends purchase paid-up additions. Then, at the appropriate time, these paid-up additions (which have their own cash value) can be surrendered back to the company with significantly more value than what they were "purchased" for. Again, the powerful illustration software available can be programmed to solve for the optimum point of purchasing and surrendering these paid-up additions in order to maximize policy values and minimize the out-of-pocket premiums paid by the policyholder. The most aggressive and volatile illustrations used a combination of these two augmentation strategies to illustrate vanishes of five years or less.

III. ABUSES OF THE VANISHING PREMIUM CONCEPT

As if the "vanishing premium" illustration concept wasn't loaded with the potential for being misleading in and of itself, experience has shown that it can be abused by companies and agents. Some of the more common abuses are as follows:

A. Illustrations That Don't Use the Company's Current Rate or Current Dividend Scale

On occasion, an agent will "neglect" to revise the illustration software package when the company revises its dividend scales, or the agent will input a higher rate than the current declared rate into his software. In the case where the dividend scale has been reduced substantially, and thus the "vanish year" has been extended a few years, running a "vanishing premium" illustration with last year's, or even last week's, dividend scale is going to mislead the policyholder into thinking that the illustrated "vanish year" is based upon the company's current dividend scale.

B. Illustrations And Agents That Don't Fully Explain The Contingencies And Risks Involved

As demonstrated above, the "vanishing premium" illustration is a house of cards: assumptions built upon assumptions projected 50 years into the future. The computer-generated numbers grid, calculated down to the very last dollar, can give the policyholder the impression that these numbers are firm and meaningful, especially when the illustrations show a column of zeros under the premium heading. Nothing could be further from the truth. ⁽¹⁸⁾ *A 1% change in the interest rate used to calculate future dividends might lead to a 100% increase in the ultimate out-of-pocket cost of the policy.* If the company has made mistakes in its pricing assumptions with regard, for example, to lapse rates, the effect of tax laws, or other critical assumptions, these errors could equally effect product performance. Imagine trying to evaluate the purchase of a life insurance policy when the multiple inherent risks of the product - all known to the company - have not been disclosed. This volatility, although it was or should have been understood by the companies, was not understood by many of the agents and almost none of the policyholders involved in "vanishing premium" sales in the 1980's. Still, most companies left the

disclosure of these contingencies and risks to the agent to be done orally, which either conventionally left the company with a scapegoat when their policies fell apart.

C. Adoption of "Current" Dividend Scales Or Projected Interest Rates Which The Company Could Not Reasonably Expect to Meet

There was very little statutory restraint upon what went into a company's "current" dividend scale during the time of most "vanishing premium" sales - principally that the company project based upon the scale it is currently using to pay dividends. In such situations, competitive pressures led companies to adopt a "current" scale based upon unrealistically optimistic hopes for the future and then project dividend payments based upon that scale. By the time the company needed to "revise" its scales to the amounts it was actually willing to pay its policyholders, several years of premiums had already been collected from policyholders who relied on that introductory scale.⁽¹⁹⁾ Regulations in Texas and other states based on the NAIC Model Regulation should curtail this practice to some extent.

D. Artificial and Unsustainable "Arbitrage" Built into Illustration

With the "super vanish" illustration described previously, there is some potential for an artificial and unsustainable "arbitrage" between the policy loan rate and the dividend interest rate. This arbitrage may cause an illustration of a particularly early "vanish year" which cannot reasonably be expected to be attained and will eventually blow up because of the inevitable disappearance of this "arbitrage."

E. Companies and Agents Fail to Appreciate and Communicate the Probability and Effect of Decrease in Dividend Rate

Most illustration footnotes say something about the expectation that dividends will possibly change from those illustrated or assumed in the "vanishing premium" illustrations. In fact, small changes in the dividend interest rates have resulted in doubling of, tripling of, and even a 9-fold increase in the amount of out-of-pocket premiums that may be necessary to get to the point where premiums "vanish." Because of the historic expectation built up over the years that companies would meet or exceed their dividend projections always and forever, less than diligent agents did not make sure that their policyholders knew of this drastic effect and the volatility of the product they were buying. Most companies likewise failed to give their agents the information and tools necessary to understand this volatility themselves.

IV. LITIGATING THE "VANISHING PREMIUM" CASE

A. Old Law--Pre-1995 Tort Reform Version of Insurance Code Art. 21.21 and DTPA

Certainly the most powerful weapon and the most cogent statutory scheme is Article 21.21 as it existed prior to the 1995 Legislature's reforms to it and the DTPA. Because the complaining policyholder can qualify as both a "consumer" under the DTPA and a "person" under Article 21.21, the cross-referencing of these two statutes to each other provides that a violation of either is a violation of both. Both statutes opened the door to recovery of treble damages and attorney's fees. Most important, however, is the incorporation by Article 21.21 § 16 of the Board Orders of the Texas Board of Insurance (now Texas Department of Insurance). In fact, there is an entire subchapter of these regulations dealing with the "advertisement" of life insurance policies. 28 T.A.C. Chapter 21, Subchapter B.⁽²⁰⁾

Pursuant to the old law's incorporation of Article 21.21 § 16(a), violation of any of the following Board Orders will support liability under the DTPA or Article 21.21:

- a. Engaging in a trade practice that is a misrepresentation of an insurance policy [28 T.A.C. § 21.03];
- b. Representing a certain cost for an insurance policy without disclosing the exclusions and limitations affecting the payment of benefits under the policy [28 T.A.C. § 21.114(4)(A)];
- c. Obscuring or failing to disclose the guaranteed rate of interest payable by the policies on written materials provided to prospective purchasers [28 T.A.C. § 21.114(4)(G)];
- d. Describing dividends in a manner that is misleading or which has the capacity or tendency to mislead [28 T.A.C. § 21.114(6)(A)];
- e. Utilizing policy illustrations that imply that the payment or amount of dividends is guaranteed [28 T.A.C. § 21.114(6)(B)];
- f. Using illustrations that imply that illustrated dividends will be or can be sufficient at a future time to assure without the future payment of premiums the receipt of benefits such as a paid-up policy without clearly and precisely explaining the benefits or coverages provided at such time and the conditions required for that to occur [28 T.A.C. § 21.114(6)(C)];
- g. Using statements and illustrations omitting material information therefrom with the capacity and tendency to mislead or deceive purchasers or prospective purchasers of insurance policies [28 T.A.C. § 21.103(d)];
- h. Using words or phrases which are misleading or deceptive because their meaning is not clear, or is clear only to persons familiar with insurance terminology [28 T.A.C. § 21.-103(d)];
- i. Using an advertisement which is not truthful or is misleading either in fact or in implication [28 T.A.C. § 21.103(a)];
- j. Using an advertisement of a policy the content and format of which is not sufficiently complete and clear as to avoid deception or which has the capacity or tendency to mislead or deceive [28 T.A.C. § 21.103(b)];
- k. Using an advertisement that, directly or by implication, has the capacity and tendency to mislead or deceive prospective purchasers with respect to an insurer's financial standing or in any other material respect [28 T.A.C. § 21.104(h)]; or
- l. Omitting information or using words, phrases, statements, references, or illustrations in an advertisement if the omission of such information or use of such words, phrases, statements, references, or illustrations has the capacity, tendency, or effect of misleading or deceiving purchasers or prospective purchasers as to the nature or extent of any loss covered, premium payable, or policy benefit payable [28 T.A.C. § 21.105(c)];
- m. Failing to clearly and conspicuously disclose current interest rates being paid or promised to be paid by an insurer and guaranteed interest rates for specific periods of time, as provided in the policy advertised, with sufficient completeness and clarity so as not to have the capacity or tendency to mislead or deceive the insured or prospective applicant [28 T.A.C. § 21.114(4)(H)];
- n. Failing to describe the consideration paid or to be paid for an insurance policy as premium, consideration, cost, payments, annuity consideration, or purchase payment [28 T.A.C. § 21.114(5)(A)];

- o. Using an advertisement of an insurance product implying that it is "a low cost plan" or using other similar words or phrases without providing a substantial present or past cost record for the policy advertised or for a similar policy that demonstrates or verifies a composite of lower production, administrative, and claim cost resulting in a low premium rate to the public [28 T.A.C. §21.114(5)(E)]; or,
- p. Illustrating dividends on a scale other than the current scale [28 T.A.C. §21.114(6)(B)].

B. New Law--Post-1995 Tort Reform Version of Insurance Code Article 21.21 and DTPA

The 1995 amendments to Article 21.21 and to the DTPA apply to causes of action which accrued after September 1, 1995, and to all suits filed after September 1, 1996 (regardless of when the cause of action accrued). Under these amendments, the incorporation of the Board Orders outlined above will no longer support liability under Article 21.21 or the DTPA by incorporation. Even so, there remains plenty of statutory bases for imposing liability under either Article 21.21 or the DTPA "laundry list," as the following demonstrate:

- a. Making or causing to be made any statement misrepresenting the terms, benefits, or advantages of an insurance policy [Tex. Ins. Code Art. 21.21, § 4(1)];
- b. Making, or directly or indirectly causing to be made, any assertion, representation, or statement with respect to insurance which is untrue, deceptive, or misleading [Art. 21.21, § 4(2)];
- c. Making, issuing, circulating or causing to be made, issued or circulated, estimates, illustrations, circulars or statements misrepresenting the dividends or share of the surplus to be received on insurance policies. [Tex. Ins. Code Art. 21.21, § 4(1)];
- d. Representing that an insurance policy has or would have characteristics, uses, benefits, or quantities that it did not have [Tex. Bus & Com. Code § 17.46(b)(5)];
- e. Representing that an insurance policy was or would be of a particular quality, standard or grade when it was of another [Tex. Bus. & Com. Code § 17.46(b)(7)];
- f. Advertising an insurance policy with the intent not to sell that policy as advertised [Tex. Bus & Com. Code § 17.46(b)(9)];
- g. Representing that an insurance policy conferred or involves rights, remedies, or obligations which it does not have or involved, or which are prohibited by law [Tex. Bus & Com. Code §17.46(b)(12)];
- h. Failing to disclose information concerning an insurance policy that was known at the time of the transaction if such failure to disclose such information was intended to induce the consumer into a transaction into which the consumer would not have entered had the information been disclosed [Tex. Bus. & Com. Code § 17.46(b)(23)];
- i. Misrepresenting the authority of a salesman, representative or agent to negotiate the final terms of a consumer transaction [Tex. Bus. & Com. Code § 17.46(b)(14)]; or,
- j. Making false or misleading statements of fact concerning the reasons for, existence of, or amount of price reductions [Tex. Bus. & Com. Code § 17.46(b)(11)].

C. Life Insurance Illustrations Regulations under 28 T.A.C. §§ 21.2201-21.2214

Texas adopted the NAIC Model Regulation on Life Insurance Illustration (No. 582) in 1998. It applies to policies sold on or after July 1, 2000. Violations of these regulations subject the insurer and agent to the penalties provided in Article 21.21 of the Insurance Code. 28 T.A.C. § 21.2212.

The regulations' stated purpose is to provide rules for life insurance policy illustrations and foster consumer education. 28 T.A.C. § 21-2201. In broad brush, the regulations define what constitutes an illustration and give requirements and formats for any sales or supplemental illustration; the regulations apply to both individual and group life term and cash value policies. Generally, besides outlawing the term "vanish" and "vanishing premium," the regulations require illustrations to be "self-supporting" within certain parameters, and they regulate the illustration of non-guaranteed elements on the policy. For a good evaluation of the Model Regulation, see Edward Mohoric, *Overview of the Life Insurance Illustrations Model Regulation*, Journal of the American Society of CLU and ChFC, May 1998 at 52.

D. Other Bases of Liability

Along with the statutory remedies of Article 21.21 and the DTPA, other causes of action are also available.

1. Fraud, Fraudulent Concealment, and Constructive Fraud

The standard elements of a common law fraud claim are that a material misrepresentation was made which was false; was made recklessly or with knowledge of its falsity; was intended to be acted upon; was relied upon; and which caused injury. *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670, 688 (Tex. 1990). In addition to the standard elements of a common law fraud claim, the insurance company-agent-policyholder relationship allows an alternate instruction regarding failure to disclose and concealment of material fact. *See, e.g., Spoljaric v. Percival Tours, Inc.*, 708 S.W.2d 432, 435 (Tex. 1986)(holding that a promise to do an act in the future is actionable fraud when made with the intention, design and purpose of deceiving, and with no intention of performing the act).

Fraudulent concealment occurs when a party conceals or fails to disclose a material fact within the knowledge of that party; the party knows that the other party is ignorant of the fact and does not have an equal opportunity to discover the truth; the party intends to induce the other party to take some action by concealing or failing to disclose the fact; and the other party suffers injury as a result of acting without knowledge of the undisclosed fact. *New Process Steel Corp. v. Steel Corp. of Texas*, 703 S.W.2d 209, 214 (Tex. App. - Houston [1st Dist.] 1985, writ ref'd n.r.e.). In the vanishing premium context, fraudulent concealment may occur in instances when, for example, the insurer concealed the methods by which returns are calculated on customers' accounts or concealed material actuarial, interest, and mortality expectations from the agents who were selling the policies to the policyholders.

In class actions alleging fraud, proof of reliance is frequently an issue that insurers argue should alone defeat class certification. The Supreme Court has held that positive proof of reliance is unnecessary in cases involving primarily a failure to disclose. *Steiner v. Southmark Corp.*, 734 F.Supp. 269 (N.D.Tex. 1990) *reconsideration denied*, 739 F.Supp. 1087 (N.D.Tex. 1990)(citing *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 153-54 (1972)). The *Ute* case created a rebuttable presumption of reliance that applies in cases in which the complaint alleges that the defendant failed to disclose any information relating to material facts the defendant was required to disclose. *Steiner* at 276.

Consumer class actions alleging fraud may be maintained so long as class members are not required to

individually litigate numerous and substantial questions to determine each member's right to recover subsequent to the ruling on the class action issues. *Wallace v. Smith Barney, Inc.*, 1997 WL 137412 *5 (Tex.App.-Beaumont (1997) (citing *Vasquez v. Superior Court of San Joaquin City*, 4 Cal.3d 800, 94 Cal.Rptr. 796, 801, 484 P.2d 964, 969 (1971)). In *Vasquez*, the California Supreme Court, citing Williston, stated that "Where representations have been made in regard to a material matter and action has been taken, in the absences of evidence showing to the contrary it will be presumed that the representations were relied on." *Vasquez*, at 814, 804, 973 (citing 12 Williston on Contracts (3d ed. 1970) 480). The *Vasquez* court further held that "if . . .the trial court finds misrepresentations were made to the class members, at least an inference of reliance would arise as to the entire class." *Id.* In *In re: Great Southern Life Ins. Co. Sales Practices Litigation*, 2000 WL 284216, *8 (N.D. Tex. Mar. 14, 2000), the court found that this "would especially be the case where the home office was telling their agents and potential policyholders that their life insurance premiums would one day soon 'vanish'." The court noted that Texas courts have cited *Vasquez* with approval. See *Life Ins. Co. of the Southwest v. Brister*, 722 S.W.2d 764, 774 (Tex.App.-Ft. Worth 1986); *Reserve Life Ins. Co. v. Kirkland*, 917 S.W.2d 836, 843 (Tex.App.-Houston [14th Dist.] 1996). While some vanishing premium cases allege omissions rather than affirmative misrepresentations, the court in *In re Great Southern Life*, which was an omissions case, addressed this distinction and found that "where a party had no opportunity to learn the truth, a presumption of reliance is warranted to a greater degree than where there is a misrepresentation." *Id.*

Another equally applicable fraud theory is fraud in the inducement, which is explained in great detail in the Texas Supreme Court's opinion in *Formosa Plastics v. Presidio Engineers*, 960 S.W.2d 41, 46-47 (Tex. 1998). Here the court held that a contract may be induced by fraud when a party promises to perform the contract while knowing it has no intention of carrying out that promise. For an example of the application of the fraudulent inducement theory in the insurance sales context, see then Dallas Court of Appeals Judge Hankinson's opinion in *Philadelphia Life Ins. Co. v. Means*, 1997 WL 488610 (Tex. App.- Dallas).

Constructive fraud is another possible fraud theory to be applied especially in cases when an agent, without his or her knowledge or intent, conveys misrepresentations directed from the home office to the policyholder. "Actual fraud involves dishonesty of purpose or intent to deceive, whereas constructive fraud is the breach of some legal or equitable duty which, irrespective of moral guilt, the law declares fraudulent because of its tendency to deceive others, to violate confidence, or to injure public interests. *Archer v. Griffith*, 390 S.W.2d 735, 740 (Tex. 1966). In constructive fraud, the actor's mental state is immaterial. *Chien v. Chien*, 759 S.W.2d 484. To show that a legal or equitable duty exists, the complaining party must show a relationship of trust and confidence between the parties. *Randall v. Dallas Power & Light Co.*, 745 S.W.2d 397, 400 (Tex.App.-Dallas 1987), *rev'd on other grounds*, 752 S.W.2d 4 (Tex. 1988). Evidence of a confidential relationship is a question of fact. *Crim Truck & Tractor Co. v. Navistar Internat'l Transp. Corp.*, 823 S.W.2d 591, 594 (Tex. 1992). Thus, the factual circumstances of the company-agent-policyholder relationship may give rise to a duty on the part of the insurance company that, if breached, would support a claim for constructive fraud irrespective of any intent or knowledge on the part of the agent or insurer.

2. Negligence and Negligent Misrepresentation

The policyholder-agent-insurer relationship will support a duty of disclosure so that a negligent failure to disclose material information can be a basis of liability. Restatement § 533. The elements for a negligence claim are existence of a duty; a breach of that duty; the breach of the duty proximately causes injuries; and damages resulted from that breach. *Boyd v. Texas Christian University, Inc.*, 8 S.W.3d 758 (Tex.App.-Ft. Worth 1999). A duty of care rises when conditions are such that a 'prudent person would

have anticipated and guarded against the occurrence which caused another's injury." *Alm v. Aluminum Co. of Am.*, 717 S.W.2d 588, 590 (Tex. 1986). In a recent opinion, the Houston Court of Appeals found that Texas does not recognize a separate cause of action for negligent supervision. *Castillo v. Gared, Inc.*, 1 S.W.3d 781 (Tex.App.-Houston [1st Dist.] August 12, 1999).

3. Negligence Per Se

Some states do not have consumer statutes like the DTPA and Article 21.21 which support a private cause of action for damages.⁽²¹⁾ In these states, it is clear, however, that the life insurance advertising regulations provide a per se standard of conduct for insurance companies and insurance agents which can support a negligence per se type of instruction in a negligence case.

4. Bad Faith

Although the duty of good faith and fair dealing has often been the subject of litigation in the insurance claims context, the relationship between policyholder and insurance company just as readily justifies its extension into the life insurance context, particularly after the original sale is made.

A claim for breach of the duty of good faith and fair dealing is separate from any claim for breach of the underlying insurance contract and the threshold of bad faith is reached only when the breach of contract is accompanied by an independent tort. *Union Bankers Ins. Co. v. Shelton*, 889 S.W.2d 278, 283 (Tex. 1994). A special relationship exists between an insurer and the insured arising out of the parties' unequal bargaining power and the exclusive control that the insurer exercises over the processing of claims and the canceling of insurance contracts. *Union Bankers Ins. Co. v. Shelton*, 889 S.W.2d 278, 283 (Tex. 1994); *Aranda v. Ins. Co. of North America*, 748 S.W.2d 210, 212 (Tex. 1988). Thus, the insurer has a duty of good faith and fair dealing. *Aranda* at 212. In the life insurance context, bad faith conduct may arise when the insurer acts unreasonably with knowledge that its acts were unreasonably or recklessly disregarded the fact that its conduct was unreasonable. Such bad faith acts may involve intentionally decreasing policy performance in an effort to maintain profitability and to compensate for the company's own actuarial and pricing errors.

5. Breach of Contract

Insurance policies are contracts and are interpreted according to the same principles that govern contract interpretation generally. *See Hernandez v. Gulf Group Lloyds*, 875 S.W.2d 691, 693 (Tex.1994). The most basic policy of contract law is the protection of the justified expectation of the parties. *DeSantis v. Wackenhut Corp.*, 793 S.W.2d 670, 676 (Tex. 1990). A court should "ascertain the intent of the parties as expressed in the instrument" when construing a written contract. *National Union Fire Ins. Co. v. CBI Indus., Inc.*, 907 S.W.2d 517, 520 (Tex.1995) (citing *Forbau v. Aetna Life Ins. Co.*, 876 S.W.2d 132, 133 (Tex.1994)).

A breach of contract requires the existence of a contract between plaintiff and defendant; a breach of the contract; causation; and damages. *Darwin v. Fugit*, 914 S.W.2d 621 (Tex.App.-Ft. Worth 1995), reh'g over'd (1996). There is no contract unless and until the application for insurance is accepted by the insurance company. *English v. Prudential Ins. Co. of America*, 928 S.W.2d 706 (Tex.App.-Houston [1st Dist.] 1996); *Walker v. Federal Kemper Life Ins. Co.*, 828 S.W.2d 442, 449 (Tex.App.-San Antonio (1992)); *American Life Ins. Co. v. Nabors*, 76 S.W.2d 497, 500 (Com.App. 1934).

6. Breach of Fiduciary Duty

Texas law specifically considers certain relationships fiduciary in nature. "For example, attorney/client, principal/agent, and partners." *UTAIC v. Mackeen & Bailey, Inc.*, 99 F.3d 645, 649 (5th Cir. 1996). Relationships that fall outside of those defined as fiduciary are considered on a case-by-case basis. *Id.* (citing *Thigpen v. Locke*, 363 S.W.2d 247, 253 (Tex. 1962)). "A fiduciary relationship 'exists in all cases . . . in which confidence has been reposed and betrayed.'" *UTAIC*, 99 F.3d at 649 (citing *Texas Bank & Trust Co. v. Moore*, 595 S.W.2d 502, 507 (Tex. 1980)). Such a relationship is created where a "special confidence is reposed in another who in equity and good conscience is bound to act in good faith and with due regard to the interests of the one reposing confidence." *Id.* "The existence of a fiduciary relationship is one of fact." *Floors Unlimited, Inc. v. Fieldcrest Canon, Inc.*, 55 F.3d 181, 188 (5th Cir. 1995). In a vanishing premium case, insurer conduct such as knowing that promised returns were not possible and failing to disclose the true formulas used to determine policy returns may give rise to a finding that the insurer was a fiduciary in dealing with purchasers of the policies. In *In re Great Southern Life Ins. Co. Sales Practices Litigation*, 2000 WL 284216, *9 (N.D. Tex. Mar. 14, 2000), the court held that "if you take money on the promise of a particular return, knowing that such a return is not possible, and you don't bother to tell anyone, you have stepped into the shoes of a fiduciary and owe those from who you take money a higher duty of care."

7. Unjust Enrichment

Recovery for unjust enrichment is proper where a party obtained a benefit from a second party by fraud, duress or the taking of an undue advantage. *Heldenfels Bros. v. City of Corpus Christi*, 832 S.W.2d 29, 41 (Tex. 1992).

8. Civil Conspiracy

An actionable civil conspiracy is a combination of two or more persons to accomplish an unlawful purpose or to accomplish a lawful by unlawful means. The elements of a civil conspiracy claim are that two or more persons agreed on an object to be accomplished; there was a meeting of the minds on the object or course of action; and there was one or more unlawful, overt acts that proximately caused plaintiff's damages. *Operation Rescue-National v. Planned Parenthood of Houston and Southeast Texas, Inc.*, 975 S.W.2d 546 (Tex. 1998).

9. Outrageous Conduct

In some other states such as Colorado, a cause of action exists for outrageous conduct. Outrageous conduct is defined as conduct that is so outrageous in character and extreme in degree as to go beyond all possible bounds of decency, and be regarded as intolerable in civilized community; and defendant either a) engaged in a pattern of conduct that was intended to cause or recklessly did cause severe emotional distress; or b) blatantly and severely harassed plaintiff in a single incident. *Destefano v. Grabrian*, 763 P.2d 275, 286 (Colo. 1998); *Simmons v. Prudential Ins. Co.*, 641 F.Supp 675, 643 (Dist. Colo. 1986). To be sustainable, a claim for outrageous conduct must be based on action that is more egregious than either the conduct underlying a bad faith breach of contract claim or a willful and wanton breach of contract claim. *Munoz v. State Farm Mut. Auto. Ins. Co.*, 968 P.2d 126 (Colo.App. 1998).

E. Defenses

1. Lack of Authority of Agent

Obviously, the insurance company will want to deny that the agent had express authority to make claims about how the policy would "pay for itself" after only a minimum amount of premium payments when

in fact the policy requires premiums to be paid for life. Even so, the doctrines of apparent authority, implied authority, and ratification can be used to attach vicarious liability to the company for the agent's misdeeds. See *Celtic Life Ins. Co. v. Coats*, 885 S.W.2d 96 (Tex. 1994); and compare Tex. Ins. Code, Art. 21.04 (Vernon's Supp. 1996).

2. Parol Evidence Rule

The parol evidence rule generally bars parol evidence to contradict the terms of the written contract. However, the exception for fraud in the inducement often swallows this rule. See, e.g., *Marburger v. Seminole Pipeline Co.*, 957 S.W.2d 82, 86 (Tex.App.--Houston [14th Dist.] 1997, writ denied); *Fidelity & Casualty Co. of N. Y. v. Burts Bros.*, 744 S.W.2d 219, 223 (Tex. App.--Houston [1st Dist.] 1987, writ denied); *Tidelands Life Ins. Co. v. Harris*, 675 S.W.2d 224, 226 (Tex. App.--Corpus Christi 1984, writ ref'd n.r.e.); *United Postage Corp. v. Kammeyer*, 581 S.W.2d 716, 720-21 (Tex. Civ. App.--Dallas 1979, no writ).

3. Statute of Limitations

Certainly, for any cause of action which arose out of conduct which occurred in the 1980's, the statutes of limitations can possibly present a bar to any recovery. Even so, the "discovery" rules of Article 21.21 (22), the DTPA (23) and at common law, if factually supported, can provide exceptions to statutes of limitations. Additionally, fraudulent concealment can keep the statute of limitations from running. *Zimmerman v. First American Title Ins. Co.*, 790 S.W.2d 690, 699 (Tex. App.--Tyler 1990, writ denied).

F. Damages and Remedies

One or more of the following measures of damages or remedies are available, depending upon the proof of liability:

1. Rescission and Restitution

This is the traditional measure of damages in common law fraud cases; however, the return of premiums paid may be an empty remedy to a policyholder who has become uninsurable, has become rateable, has retired or has had enough birthdays to make replacement insurance out of reach.

2. Benefit of the Bargain

Both the DTPA and Article 21.21 have been read to confirm the traditional common law notions of appropriate remedies. "Benefit of the bargain" has thus been approved as one measure of damages which is available. See e.g., *W. O. Bankston Nissan, Inc. v. Walters*, 754 S.W.2d 127 (Tex. 1988). The benefit-of-the-bargain measure computes the difference between the value as represented and the value received. *Arthur Andersen & Co.*, 945 S.W.2d 812, 817. Under the benefit-of-the-bargain method, the plaintiff can recover lost profits if they are proved with reasonable certainty. See *Formosa Plastics*, 960 S.W.2d at 50 (citing Restatement (Second) of Torts § 549(2) (1977)). Although the benefit-of-the-bargain measure can include loss of profits, it compensates only the profits the plaintiff would have made if the bargain had been performed as promised. *Id.* In essence, therefore, the policyholder should be able to recover an amount of money that would enable him to obtain the policy benefits sought (e.g., death benefit of \$1 million and/or cash build-ups of \$100,000 by tenth year) on a guaranteed basis, assuming that was the expectation of the policyholder. This cost will of course be considerably more than the "projected" cost using non-guaranteed values; however, that is, in essence, what the policyholder bargained for when he bought off on the "vanishing premium" illustration. It may be

appropriate to measure the cost of this insurance to the policyholder at the time of trial in order to adequately compensate the policyholder.

3. Prejudgment Interest and the Trebling of Damages and Attorney's Fees under Article 21.21

Prejudgment interest (which can accrue at 10% back to the original sale date of the policy) is an essential element of damages. It can greatly increase the amount of the recovery made. *See, e.g., St. Paul Surplus Lines Insurance Co. v. Dal-Worth Tank Co.*, 974 S.W.2d 51, 55 (Tex. 1989). Furthermore, under Article 21.21 Sec. 16(b)(1), a prevailing plaintiff may obtain actual damages plus court costs and reasonable and necessary attorney's fees. In addition, "if the trier of fact finds that the defendant knowingly committed the acts complained of, the trier of fact may award not more than three times the amount of actual damages." Article 21.21 Sec.16(b)(1). Prejudgment interest, however, may not be included in the "actual damages" trebled. *St. Paul*, 974 S.W.2d at 55.

4. Reformation/Specific Performance

The equitable remedies of reformation and specific performance may likewise be available, depending upon the theory and jury findings. *See, e.g., Tex. Bus. & Com. Code § 17.50(b)(3); Tex. Ins. Code, Art. 21.21, § 16(b)(3)*. Reformation is available where there is the presence of mutual mistake or where there is a "unilateral mistake by one party and knowledge of that mistake by the other party . . ." *Davis v. Grammar*, 750 S.W.2d 766, 768 (Tex. 1988)

G. Claims of the Agent Against the Company

Lawyers who find themselves representing the agent in a "vanishing premium" or other misrepresentation case should consider bringing a cross-claim against the insurance company. The Texas Supreme Court recently held in *Crown Life Ins. Co. v. Casteel* that an agent, who had been sued by a number of his customers for misrepresentation in the sale of "vanishing premium" policies, had standing to bring a cross-claim against the insurance company under Article 21.21 §16(a) for actual damages. 2000 WL 72142 (Tex.). Thus, under this theory, the insurance company can be liable not only to its customers but to its agent for misrepresentations. The court held, however, that the agent did not have "consumer" status to bring a claim under Article 21.21 to allege DTPA-based claims.

H. Class Actions

The landmark case on the "vanishing premium" problem in the class action context is a settlement of a certified class of over 8 million policyholders in *In re Prudential Ins. Co. of America Sales Practices Litigation*, 148 F.3d 283 (3rd Cir. 1998), *cert. denied*, ___ U.S. ___, 119 S.Ct. 890, 142 L.Ed.2d 789 (1999). Numerous other courts have affirmed certification of classes of "vanishing premium" policyholders. *See, e.g., Jacobson v. Security-Connecticut Life Ins. Co.*, 25 Conn. L. Rptr. 369, 1999 WL 732588 (Super. Ct. Conn. 1999); *Bussie v. Allmerica Financial Corp.*, 50 F.Supp.2d 59 (D. Mass. 1999); *Elkins v. Equitable Life Ins. Co.*, 1998 WL 133741 (M.D. Fla. 1998); *Duhaime v. John Hancock Mutual Life Ins. Co.*, 177 F.R.D. 54 (D. Mass. 1997). While the above cases were settlement classes, other courts have certified contested "vanishing premium" classes. *See, e.g., In re: Great Southern Life Ins. Co. Sales Practices Litigation*, 2000 WL 284216 (N.D. Tex. Mar. 14, 2000), *Security Life of Denver Insurance Company v. Ferguson*, 1999 WL 339017 (Tex.App.-Dallas)); *In re New England Mutual Life Ins. Co. Sales Practices Litigation*, 183 F.R.D. 33 (D. Mass. 1998), *Justice v. Great-West Life Assurance Company*, Cause No. 94-3155 (Dallas 192nd, Nov. 13, 1995). The Supreme Court of Ohio has also upheld the class action as an appropriate procedure for resolving factually similar "churning" allegations. *Cope v. Met. Life Ins. Co.*, 696 N.E.2d 1001 (Ohio 1998) ("Indeed, we cannot imagine a

case more suited for class action treatment than this one.").

Just one of the important issues in the certification of any "vanishing premium" class action is the manageability of the class action trial under Tex. R. Civ. P. 42(b)(4)(D). Courts are often asked in the "vanishing premium" context to certify a class for settlement or trial where the laws of multiple states will apply to members of the class. Managing a multi-state class action need not be as difficult as it may appear at first glance. In fact, multi-state classes offer the advantage of reducing the time and cost associated with complex litigation and conserving judicial resources.

Multi-state classes are based on the premise that the proposed class members suffered the same or similar injuries due to the same individual action or similar repetitive actions by the defendant. Class proponents bear the burden of showing that the factual similarities of the plaintiffs injuries and the similarities among the applicable states' laws predominate over any differences in state law. *Walsh v. Ford Motor Co.*, 807 F.2d 1000, 1016-17 (D.C. Cir. 1986). Generally, this burden is easily met: discovery of company documents and depositions of company marketing personnel will show that the focus of the company's efforts were directed at making sales through the "vanishing premium" scheme. As the United States Supreme Court has held, "Predominance is a test readily met in certain cases involving alleging consumer or securities fraud or violations of antitrust laws." *Amchem Products, Inc. v. Windsor*, 521 U.S. 591 (1997).

To address any possible differences in state law, it may be helpful to prepare a grid for the court that clearly shows the lack of contradiction between the law of the forum state and the law of the other states represented in the class. Two federal courts that have approved complex multi-state settlements commended the plaintiffs' attorneys for preparing charts comparing the applicable state laws covered within the suit. *In re Prudential Ins. Co. of America Sales Practices Litig.*, 148 F.3d 283 (3rd Cir. 1998) (deceptive insurance sales practices); *In re School Asbestos Litig.*, 921 F.2d 1310 (3rd Cir. 1990), *cert. denied sub nom. U.S. Gypsum Co. v. Barnwell Sch. Dist.*, 499 U.S. 976 (1991).

A court may also decide that the facts of the case support application of a single state's law to multi-state class members' claims. As the Supreme Court recognized in *Phillips Petrol. v. Shutts*, there is no bar to a multi-state class action, so long as the choice of law is not arbitrary or unfair. 472 U.S. 797, 821, 105 S.Ct. 2965, 2979 (1985). For its law to apply, the Supreme Court held the state must have a "significant contact or significant aggregation of contacts to the claims asserted by each member of the plaintiff class, contacts creating state interests." Such significant contacts exist in the "vanishing premium" context because companies design their products, devise marketing materials, train agents, and distribute product all from their home states. It is neither arbitrary or unfair in those instances to apply the home state's laws to conduct undertaken from the home forum.

This single-state's law approach is supported by the "interest analysis" of Texas choice-of-law rules adopted from the Restatement (Second) of Conflicts of Law. Moreover, this approach is supported by the American Law Institute's special choice-of-law rules on "Mass Torts" and "Mass Contracts," which direct courts to apply "the law of the state where the conduct causing the injury occurred" and "the law of the state in which the common contracting party has its primary place of business," respectively. *Complex Litigation: Statutory Recommendations and Analysis*, §§ 6.01 and 6.03 (1994).

Trial courts have the authority to bind all multi-state class members to the court's judgment in suit brought under a state law claim. *Phillips Petroleum Co. v. Shutts*, 472 U.S. 797, 814 (1985), *cert. denied*, 487 U.S. 1223 (1998). In a multi-state suit, the forum court has the authority to interpret and apply the laws of foreign states. *Sun Oil v. Wortman*, 486 U.S. 717, 730-31 (1988). The forum state's interpretation of the law will be upheld as valid unless that court misconstrued a law that was both clearly established and brought to that court's attention. *Id.* This is true even though some class members

may never have set foot in the state.

If actual contradictions in state law are present, counsel may request certification of various subclasses to account for the variations under Fed. R. Civ. P. 23(c)(4). In Texas, a trial court may create subclasses pursuant to Tex. R. Civ. P. 42(d) if it finds that other states' laws should apply to certain class members. *Microsoft Corp. v. Manning*, 914 S.W.2d 602 (Tex. App.--Texarkana 1995, writ dismissed). Subclasses are the preferred method of resolving conflicts of law so long as the conflicts do not undermine the attorney's ability to represent the interests of all class members.

1. In fact, a surprising number of the "vanishing premium" plaintiffs have been attorneys. Testimony from various life insurance agents likewise bears out the fact that attorneys, like other professionals, are not sophisticated in life insurance concepts and have to "trust" their agents to a large extent, just like the rest of the general public. And, in the *Ferguson v. Crown Life* case, the agent himself testified he did not fully understand what he was selling!

2. See, e.g., "Prudential is Prepared to Pay \$1 Billion to Settle Claims of Sales-Practice Abuses," *Street Journal*, February 16, 1996; "New York Life Agrees to Settle Lawsuit Over its "Vanishing Premium" Policies," *Wall Street Journal*, August 15, 1995 (report of class-action settlement valued at \$65 Million); "Great West Offers \$30 Million Settlement in `Vanish Suit'," *National Underwriter*, October 23, 1995; "'Vanishing Premiums' Case Is Settled At \$100 Million," *Wall Street Journal*, August 16, 1996; "Crown Life Loses a \$50 Million Ruling Involving `Vanishing Premium' Policies," *Wall Street Journal*, September 13, 1995; "Vanishing Premium Verdicts Costs Equitable \$6.5 Million Dollars," *National Underwriter*, April 29, 1996; "Prudential Insurance Liable for Fraud, Poor Supervision," *National Law Journal*, May 2, 1994 (reporting \$25.4 Million verdict in Babour County, Alabama case); a "Jury Awards Retiree \$25 Million in Fraud Case," *National Law Journal*, September 25, 1995 (reporting Marshall County, Alabama verdict).

3. This is to be distinguished from "vanishing premium" illustrations which illustrate the possibility that premiums may be paid out-of-pocket for a certain number of years and then paid through dividends or other policy values in future years, all of which is contingent upon the company's future earnings.

4. Dividends may not be called dividends by the company. At least one company refers to its dividend as an "excess interest credit" and guarantees that a declared interest rate, i.e. 9%, will be used to calculate that "excess interest credit" for the first policy year. After that, they will periodically declare a new interest rate and use it to pay the "excess interest credit." There appears to be little difference, at least in the mind of this company, between the "excess interest credit" and the more common "dividend" except the disclosure of the actual interest rate used in its calculation. Whether anyone who actually read the contract would understand the difference between a regular three-factor dividend and an excess *interest* credit is a different matter altogether.

5. In fact, many life insurance agents mistakenly refer to the dividend as a "return of premium" because it is viewed as an overcharge for the insurance provided. When comparing the prices of whole life policies with the prices of term policies, it is easy to see why this "overcharge" misconception has developed.

6. Insurance companies are somewhat restricted from favoring one group of policyholders over another when it comes to paying dividends unless there is a sound actuarial basis for doing so. Likewise, dividends will be calculated to bear a reasonable relationship to the earnings and expenses of the

particular block of insurance policies on which dividends are being paid.

7. Participating whole life policies usually do not generate dividends during the first two or three years of the policy because of expenses incurred by the company in "booking" the policy. Commissions and administrative expenses for the first policy year often exceed the amount of the first year's premium. As such, there is no excess cash available from the premium dollars paid for the company to invest until the second or third policy year. For this reason, neither guaranteed cash values nor dividends are seen by the policyholder during these first couple of years.

8. In the Crown Life litigation, the plaintiffs sought discovery of this dividend formula. In resisting discovery, Crown Life requested that the Court order the plaintiffs to post a \$12 million bond to protect Crown Life from unauthorized disclosure of this dividend formula. The Court eventually agreed to Crown Life's request for an indemnity bond, but only in the amount of \$250,000.00.

9. With regard to the problem of missing the mark on lapse assumptions, see Richard A. Schwartz, "Incongruous Lapse-Supported Product," *Best's Review* (Dec. 1991) at 31.

10. The agent, who is paid a percentage of each premium as a commission, has a great incentive for your premiums to be paid each year, regardless of whether the premium is paid by new cash or by a policy loan.

11. Typically, this proprietary software is encoded to contain all of the company's pricing assumptions and dividend scales. New software is supposed to be distributed and used with each new pricing change or dividend scale change. However, sometimes the software might have errors, and sometimes agents fail to update their software to timely reflect these changes. Unless an illustration accompanies the application and is checked by someone at home office, administrative personnel at home office will not know which illustration has been used to make the policy sale.

12. Before 1983, state regulations required that policy loan rates be fixed (i.e. 6%, then 8%). With double digit inflation, these low loan rates worked to keep dividends artificially low because of the potential for unchecked arbitrage. For instance, a company would not want to encourage a policyholder to take out a 6% loan to pay his premium by rewarding him with a dividend based upon a dividend credit rate of 11% or 12%.

13. Some companies were more aggressive than others. For an account of one of the most aggressive and prolific companies during this era, Executive Life Insurance Company, see the book written by Gary Schulte, *The Fall of First Executive: The House That Fred Carr Built* (Harper Business Press 1991).

14. Of course, an additional benefit to agents (who receive commissions out of each future premium payment) is that they could look forward to receiving their commission checks regardless of whether the insured paid the premiums out of his pocket or through future dividends.

15. But there are several other factors that go into setting the dividend scale, including company expenses, mortality, and persistency, which may have an equally great effect on policy performance. Because these factors are often invisible to both policyholders and agents, it is exceedingly difficult for them to make reasoned judgments about the risks of purchasing a whole life policy. After all, these policies are usually referred to as "interest-sensitive" policies, which is a description that leaves out a plethora of other risks that the company might pass along to the policyholder in the form of lower returns.

16. In fact, there is no legal requirement in the United States that insurance companies with participating policies pay dividends at all. In Canada, a specific percentage of divisible surplus, if any, must be returned to the owner of a participating policy each year. Still, there is no legal requirement for the manner of its distribution.

17. Such arbitrage would of course be very beneficial to the policyholder were it to continue indefinitely into the future. However, by being contractually tied to a high-yield market indicator, the variable loan rate is designed to, on average, float above the dividend interest rate. Thus, any such arbitrage would be expected to "vanish" itself when dividend scales are revised. While the illustration may project this arbitrage indefinitely into the future, the company (but perhaps not the policyholder) would thus know that this arbitrage would disappear within two years or less.

18. For an in-depth discussion of illustration practices by the industry itself, see The Society Of Actuaries Task Force Report on Life Insurance Illustration Practices (1992), which concluded that the use of exact numbers calculated out to the last dollar was misleading to consumers.

19. As an example, assume a policy is introduced for the first time in 1983. Even the first policy sold will probably not earn a dividend until 1986. Still, in 1983, the company gets to set a dividend scale for 10, 20, 30, and 40-year-old policies, even though there are no such policies, much less dividends to pay on those policies. By 1986, when the first dividend is paid on the first policy issued, the company may want to "revise" its current scale for dividends for three-year-old policies. The policyholder, however, has already paid three years of premiums before this revision occurs. Even so, the company can continue, in 1986, to project what it will pay in dividends on policies 10, 20 and 30 years old even though it still has never paid a penny in dividends on any policy more than three years old.

20. The term "advertisement" is broadly defined to include just about every scrap of paper that might be put before a prospective policyholder during the sale of a life insurance policy. 28 T.A.C. § 21.102(1) (West 1996). The "vanishing premium" illustration clearly meets the definition of "advertisement" given by these regulations.

21. As with most insurance regulations, life insurance advertisement regulations have been adopted more or less uniformly by most other states. However, Texas appears to be one of the only states which, at least until September 1, 1996, specifically allowed a violation of these advertising regulations to support a statutory cause of action for money damages.

22. Tex. Ins. Code, Art. 21.21, § 16(d) (Vernon's Supp. 1996).

23. Tex. Civ. Prac. & Rem. Code § 17.565 (Vernon's Supp. 1996).