The Annuity Conundrum:
Responding to the Abuse of Elderly Investors

By Joseph H. Aughtman

Joseph H. Aughtman *is a shareholder in the law firm of Beasley, Allen, Crow, Methvin, Portis & Miles, P.C., in Montgomery, Alabama. He has a national practice, part of which focuses on representing plaintiffs in class actions against the insurance and financial services industry, as well as complex commercial litigation. Currently, Aughtman is lead or co-lead counsel in 14 national class actions across the country. He can be reached at jay.aughtman@beasleyallen.com.*

An annuity is a contract between an investor and an issuer whereby the investor agrees to give the issuer principal and, in return, the issuer guarantees the investor fixed or variable payments over time. While annuities are not insurance policies, they are typically issued by insurance companies. An annuity is similar to a retirement plan in that one can fund it in a lump sum or a little at a time, and all capital in an annuity grows and usually compounds tax-deferred until one begins making withdrawals. Unlike retirement plans, however, there is no limit as to how much one can invest in annuities. Annuities are marketed as instruments to protect investors' principal.

And yet, with a frequency that is disturbing, annuities are being used as instruments to defraud investors. Rather than protecting the principal of investors, the complexity of annuity provisions has been used to fleece people of their savings, especially those of senior citizens. In response, plaintiffs firms have entered the fray and started class actions across the nation.

Understanding the Basics

When selecting an annuity, an investor is presented with essentially three choices. The first issue is the timing of payout—immediate or deferred. In an immediate annuity, the investor begins to receive payments immediately upon investing. This is for investors who need immediate income from their annuity. In a deferred annuity, the investor receives payments starting at some later date, usually at retirement. The next issue involves investment type—fixed or variable. Fixed annuities are invested primarily in government securities and high-grade corporate bonds. They offer a guaranteed rate, typically over a period of one to ten years. In contrast, variable annuities enable an investor to invest in a selection of subaccounts, such as securities, fixed interest accounts, and money market securities. These subaccounts are tied to market performance and often have a corresponding managed investment portfolio, after which they are modeled. Finally, one has to consider the issue of liquidity options. Most annuities allow an investor to withdraw either his or her interest earnings or up to 15 percent per year without a penalty, although any withdrawal from an annuity may be subject to taxes and a 10 percent federal penalty if taken prior to 59½ years of age. Most annuities have a surrender charge, i.e., a penalty for making an early withdrawal above the free withdrawal amount. Typically, this surrender charge decreases over a seven-year period.

Fixed indexed annuities. A fixed indexed annuity is one that grows at the greater of (1) an annual, guaranteed minimum rate of return or (2) the return from a specified stock market index (such as the Standard & Poor's 500), reduced by certain expenses and formulas. At the time the contract is opened, a term is chosen, which is the number of years that the principal is guaranteed.

Technically speaking, fixed indexed annuities are a type of fixed annuity. But a fixed indexed annuity is different than a standard fixed annuity in the way that earnings are credited to the annuity. For a standard fixed annuity, the issuing insurance company guarantees a minimum interest rate. The focus is on safety of principal and stable, predictable investment returns. With fixed indexed annuities, the contract return is the greater of (1) an annual minimum rate or (2) the return of a stock market index reduced by certain expenses and formulas. If the chosen index rises sufficiently during a specified period, a greater return is credited to the owner's account for that period. If the stock market index does not rise sufficiently, or even declines, the lower minimum rate is credited. The owner is guaranteed to receive back at least all principal, provided that the owner has held the contract for the minimum period of time specified in the contract.

Bonus annuities. Some annuities with surrender charges reward the investor by offering a bonus: the insurance company adds an average of 3 to 5 percent to each of your premium payments. For example, if one invests $10,000 in a bonus annuity, the insurance company will add $300 to $500. The trade-off is that with a bonus annuity the surrender period (the number of years a penalty is assessed for withdrawals) is usually longer (eight to nine years in most cases, versus the typical five- to seven-year surrender), and each subsequent bonus payment will have its own eight- or nine-year surrender period, making access and liquidity more difficult.

Some bonus annuities offer a first-year-only bonus of 1 to 4 percent above the contract's guaranteed or base rate. This creates an additional bump in the initial annuity deposit value. But beware that the subsequent year's expenses and renewal rates may be lower, so that the insurance company can recapture the first-year payment. This can drive the overall return down.

When exploring bonus annuities, an investor should be aware of several other things. First, bonus annuities typically pay the broker a lower upfront commission; therefore, a broker or agent may not volunteer that bonus annuities are available. Second, investors must be certain to compare the annual fees and track record of the fund (if applicable to your bonus type) compared with the company's standard nonbonus product. The nonbonus product may have more value over time.

Variable annuities. Variable annuities invest in a selection of funds, called subaccounts. These subaccounts are tied to stock market performance, like mutual funds. A variable annuity is similar to a retirement plan in that an investor can fund it in a lump sum or a little at a time, and all capital in the annuity grows and compounds tax-deferred until the investor begins making withdrawals. Variable annuities typically charge high fees, from 2 to 3 percent. Many times this is in excess of annual fees on direct mutual funds.

Where Abuse Creeps In

Vulnerability of seniors. While the selling of unsuitable annuities is harmful to all consumers, seniors remain by far the most vulnerable. According to Consumer Action, a consumer advocacy group, people 60 and older make up 15 percent of the U.S. population, but they account for about 30 percent of fraud victims. There are many reasons for this statistic, especially as it relates to annuities. First, annuities, by their very nature, are complex. Second, many seniors, because of their age, often have diminished capacity to understand complex investment transactions. Many also have a heightened fear of outliving their assets. After a lifetime of saving money to retire, seniors harbor serious concerns about risky investments and worry about being a burden to their families or left alone in a nursing home. As such, seniors who may have no real familiarity with financial planning can be easy prey for unscrupulous insurance companies and are lulled into a false sense of security by their sales agents. Unfortunately, most seniors do not discover the fraud until it is too late. The fraud often goes unnoticed because many seniors are too embarrassed to report the fraud or are afraid of seeming to be unfit to manage their finances and lives.

Changing distribution channels. Most annuities, regardless of the type, are now sold by distribution channels of a nontraditional nature. Gone are the days of the "captive" agent knocking on one's door or inviting an investor into his or her company-sponsored office in the investor's home town to sell these products. Those traditional channels have been replaced by independent channels that consist of agents who do not work exclusively for any one particular insurance company. Most independent distribution channels are comprised of agents who are appointed and/or licensed by various insurance companies for selling their annuity products.

When dealing with an independent agent, one of the advantages for purchasers of annuities is that the selection of annuity products should be greater than if the customer went to an insurance company's captive agent. Ideally, this allows the independent agent and a customer to make a more informed decision as to which annuity product best suits the customer's needs. Of course, different insurance companies offer different commission levels and incentives for their independent agents, and a consumer should always inquire as to the commission charges being assessed in the purchase of any annuity.

One channel of annuity sales that has become quite common is the use of commercial banks as independent distribution channels. Banks have become one of the leading marketers of deferred annuities, which are only regulated by state insurance departments. Because any bank employee, loan officer, or customer service representative can obtain a state insurance license by passing the state-required examination, insurance companies across the country have negotiated contracts with many of the larger and midsized commercial banks for selling these products. Banks have a captive clientele for which they can monitor account balances, certificates of deposit renewals, and other forms of cash transactions. Such customers can be easy prey for "friendly" bankers.

Commercial banks have become more aggressive in proactively seeking out their own customers for deferred annuity sales. Often, bank employees selling annuities have not received significant training from the insurance company underwriting the product. Consumers should be cautious in purchasing as complicated a product as an annuity from anyone who is not duly qualified and trained in all aspects of the instrument.

The Legal Response

Annuity class actions. Since 2004 many of the leading class action plaintiff firms across the country have waded into the annuity class action arena. Most of the cases brought against a variety of life insurers concerning annuity sales focus on the suitability of those products to seniors. The cases essentially argue that the products are unsuitable for seniors by the fact they impose steep surrender charges and/or undisclosed fees and expenses to the elderly when they can least afford it and when they need the most conservation and liquidity of their investment portfolios. Cases were filed against American Investors, American Equity, and Midland National alleging schemes that targeted seniors to purchase unsuitable products.[1] Allianz, Fidelity and Guaranty, National Western, AIG, AmerUs, and several other major insurers have also been sued in class actions on behalf of seniors over suitability issues.[2]

Some insurers have been sued regarding the bonus feature marketing in some deferred annuity products. AIG, Lincoln National, and John Hancock were all named as defendants in separate lawsuits in various jurisdictions for fraudulently representing first-year bonus products as guaranteeing the bonus permanently in the contract.[3] The claims in those cases also allege the insurers had breached the annuity contracts by the fact they failed to disclose they recapture the first-year bonus through secret fees or charges and interest rate spreads in years two through six of the contract.

Tracking companies and sales agents. Insurance companies are aware that deceptive marketing and sales practices to induce seniors to purchase unsuitable deferred annuities are being employed by numerous sales agents throughout the nation. Indeed, many of the most powerful insurance companies actually sponsor or provide funding for training seminars that explicitly teach sales agents how to target seniors. In these seminars the agents are taught to discover if the seniors have assets that can be used to purchase an annuity product and how to convince the senior to purchase an annuity. Perhaps most telling, however, is that these companies encourage agents to sell unsuitable annuities to seniors by offering enormous sales incentives, commissions, and other promotions to maintain or increase market share from the sale of deferred annuities.

The insurance companies, however, pretend to be innocent and unaware of anything about the agents' unethical sales practices. Some insurance companies respond that they have suitability policies and procedures that they monitor and ensure against a sales agent's fraudulent business practices, and have issued annuity contracts that are clear and understandable. Ironically, the same insurance companies also prepare and/or approve instruction, training, sales procedures, and marketing materials for sales agents to use to sell deferred annuities to seniors. In some cases, insurance companies formulate their sales practices and procedures in such a way that their practices no longer adhere to the statutory obligations required for selling deferred annuities to seniors. Moreover, many annuity contracts are intentionally drafted so that the average person, let alone an elderly person, cannot readily understand the terms.

Furthermore, despite their arguments, most insurance companies completely ignore statutory requirements that agents must provide documentation that they have reviewed and verified the suitability of their deferred annuity products for the seniors who purchased the product. And due diligence by the agent to prevent misleading or incomplete sales presentations is completely absent.

Conclusion

Litigation concerning annuities continues to grow in the United States. The issues and related causes of action concerning annuity investments will continue as long as insurance companies and their agents target society's most vulnerable citizens.

Notes

1. *See, e.g.*, *In re* Am. Investors Life Ins. Co. Annuity Mktg & Sales Practices Litig, 2008 WL 2246989 (E.D. Pa. 2008); Bendzak v. Midland Nat'l Life Ins. Co., 240 F.R.D. 449 (S.D. Iowa 2007).

2. *See, e.g.,* Mooney v. Allianz Life Ins. Co. of N. Am., 244 F.R.D. 531 (D. Minn. 2007).

3. *See* Cirzoveto v. AIG Annuity Ins. Co., No. 06-2534 (W.D. Tenn. filed Aug. 18, 2006); Sayer v. AmSouth Inv. Servs., No. 06-15813, 2007 WL 1847703 (11th Cir. June 28, 2007); Smith v. John Hancock Life Ins. Co., No. 06-3876 (E.D. Pa. filed Aug. 31, 2006).