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How Life Insurance Morphed Into a Corporate Finance Tool

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After the Sept. 11 terror attacks, some of the first life-insurance payouts went not to the victims' families, but to their employers.

Unknown to most people outside the insurance world, corporations now are among the largest beneficiaries of life insurance, collecting on policies they purchased on the lives of employees.

WHAT THE WORKERS DON'T KNOW

- Companies Profit on Workers' Deaths Through 'Dead Peasants' Insurance[4] 04/19/02
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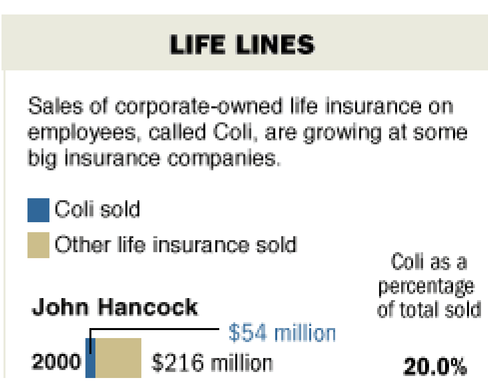
Life insurance has long been championed as a safety net for widows and orphans. But over the past decade and a half, hundreds of American companies have taken out life insurance on millions of their employees, harvesting tax advantages that fatten their coffers.

In the industry, companies' coverage of the lives of low-level workers is called "janitors insurance." It has two notable features: Most of the workers never consented to the coverage, and it remains in force even if they've long since left the company.

Recently, employers have been taking out larger policies on the lives of managers, usually with their consent. Like janitors insurance, these policies make the employer, not the family, the beneficiary.

The Tax Allure

Neither buyers nor sellers of this insurance disclose much about it. Among the few traces of the Sept. 11 payouts was **Hartford Life Insurance** Co.'s fleeting reference, in a quarterly regulatory filing, to an after-tax charge of $2 million related to the Sept. 11 attacks. Hartford confirms that the payout itself was greater than the net charge and that it went to employers. It declines to give other details.



For employers that buy these policies, tax strategy is the driving force. The money they pour into life insurance grows tax-free. Gains on the investments within the policies flow to the companies' income statements each year.

This isn't cash income. It's paper profit, which the employer isn't, at first, free to spend. But little by little, deaths of employees and former employees unlock the paper profits. With the deaths, the employers receive death benefits, which, like those a family receives on a loved one, aren't taxed.

The Internal Revenue Service has invalidated, as "sham" transactions, some of the tax benefits claimed by employers in past years. Several courts have endorsed the IRS position. Employers have also been on the losing end, so far, of suits by workers' families challenging their right to insure the workers' lives.

For some big insurers, meanwhile, sales of corporate-owned life insurance are a source of growth as traditional sales stagnate. In the first nine months of this year, **Mony Group** Inc.'s sales of life insurance to companies soared 128% from a year earlier, to $124 million, while its other life-insurance sales fell 3% to $94 million. Industrywide, corporate sales now make up 25% to 30% of life-insurance sales, insurance experts say.

Shifting Strategies

Yet corporate-owned life insurance is controversial even within the industry. John H. Biggs, chairman and chief executive of annuity giant TIAA-CREF, calls it "a form of insurance that's always seemed revolting to me."

The legal and tax landscapes have been changing through the years. Along the way, employers and consultants have changed their strategies as well, to continue to make insuring the lives of workers a paying proposition.

It adds up to a little-known story of how life insurance morphed from a safety net for the bereaved into a strategy of corporate finance.

The story begins in the 1980s. Employers had long insured the lives of their most important executives, to protect themselves. "Key man" policies, as these were called, weren't new.

Nor was the type of insurance. Instead of simple, inexpensive "term" insurance, which protects for a set period, companies bought the kinds called "whole life" and "universal life." These don't have a time limit. They're essentially investment funds for the buyer with a death benefit attached. The critical advantage is that, since they're a form of life insurance, the money in them accumulates untaxed.

HOW DO THEY DO IT?

See an article on how companies [1] use life insurance on employees to get a variety of tax and accounting benefits that help to boost the bottom line.

What changed in the 1980s was that some companies began shoveling huge amounts of money into key-man policies. They sought both tax-free buildup and another advantage: They could borrow from the policies and deduct the interest. The combination yielded rich benefits with little risk.

By the mid-1980s, companies were pouring so much into the policies that Congress, sensing a misuse of life insurance, cracked down. A 1986 law said only the interest on the first $50,000 borrowed on a given policy would be deductible.

Companies quickly found a way around the cap: Buy a great many policies. If they insured thousands of employees, not just "key men," they could continue placing large sums in life-insurance contracts and taking out large tax-deductible loans.

"They thought, 'Well, if we can do it for 200, why not for 20,000?' " says Kenneth Kirk, who worked at **Clark/Bardes** Inc. That firm, a publicly held insurance broker and consultant, has played a central role in the evolution of corporate-owned life insurance.

See a chart of the history[1] of U.S. employment insurance.

One company Clark/Bardes worked with was **Dow Chemical** Co. When the Midland, Mich., company decided to have a look at the strategy, it saw an obstacle. Like many states, Michigan required that a beneficiary of a life-insurance policy have an "insurable interest" -- that is, the beneficiary would benefit from the insured's continued life and be harmed by the insured's death. Alas, said a Dow Chemical internal memo, except for top-paid executives, it was "doubtful that Dow has an insurable interest in any of its employees."

But Clark/Bardes lobbied the Michigan legislature to agree that employers are harmed when even low-level workers die. Reason: the cost of hiring and training replacements and providing future employee benefits. Michigan agreed to the change. And by 1992, Dow Chemical had bought life-insurance policies on more than 20,000 employees.

Amid lobbying throughout the 1990s, the Michigan legislature chipped away at other requirements, including one that insurance proceeds be used for employee benefits. Thanks to lobbying by Clark/Bardes and others, Michigan and many other states handed employers a near-blanket insurable interest on their workers by the mid-1990s. Some other states followed later, including Texas in 1999.

The lobbyists said employers would use life insurance's tax advantages to finance employee benefits. "The main reason employers are buying life insurance is so that they can provide benefits, in particular retiree medical benefits," says Jack Dolan, a spokesman for the American Council of Life Insurers.

The link to benefits is a tenuous one, however. For one thing, the tax-free buildup in policies isn't cash that employers are free to spend, until covered employees die. Secondly, the gains go into the general corporate pot. "The assets are fungible," Mr. Dolan acknowledges.

Moreover, employers have been cutting retiree health coverage throughout the 1990s, even as they were buying more life insurance. And some that bought janitors insurance didn't offer retiree health coverage to the rank-and-file workers whose lives they were insuring. An example is **Hillenbrand Industries** Inc., a coffin maker in Batesville, Ind. A spokesman for Hillenbrand says it bought the policies to beef up other employee benefits.

Tom Wamberg, Clark/Bardes's chairman and chief executive, says that "even though there's no lockbox, those programs are, in [employers'] minds, dedicated" to employee benefits.

In many states, it ceased to matter. Thanks to lobbying by Mr. Wamberg's firm and others, many states eventually dropped the requirement that corporate-owned life insurance be used to finance employee benefits. Across the U.S., millions of workers soon were being insured by hundreds of employers, among them **AT&T** Corp., Nestle USA and Amway.

Unmarked Envelope

In Congress, few knew how big a deal this was until a brown envelope arrived in 1995 on the desk of Ken Kies, chief of staff at the Joint Tax Committee. According to Mr. Kies, inside was a list of companies that had bought life insurance on employees -- along with calculations showing how a company might take in $1.2 billion over 10 years by insuring 50,000 of its people. One nugget Congress learned: **Wal-Mart Stores** Inc. had made itself the beneficiary of insurance on 350,000 workers' lives from 1993 to 1995.

Seeing a big cost to federal coffers, Congress in 1996 voted a three-year phaseout of all deductions for interest on loans against life insurance. The Joint Tax Committee estimated the saving to the Treasury at $16 billion over 10 years.

With no more $50,000-per-policy cap, companies had no more need to buy policies on large numbers of employees. They basically stopped buying janitors insurance policies. And while generally keeping these policies in force, they stopped borrowing against them.

Companies still had a big incentive to own life insurance, though: the tax-free buildup. And they found a way around the interest-deduction crackdown. They simply borrowed elsewhere, with interest that was still deductible, and then bought more insurance. "Indirect leverage," this was called.

Indirect leverage was especially appealing to banks, since they can borrow money cheaply. Banks bought fresh policies on employees. By 1997, some were looking into insuring the lives of depositors and credit-card holders, as well. And **Fannie Mae**, the giant mortgage buyer, proposed to insure the lives of home-mortgage holders.

That was too much for Congress. It nixed these innovations by going after any loans that a firm might use to buy life insurance on depositors or mortgage holders. The formula: If such a firm bought X amount of life insurance, then for X amount of that firm's loans, interest wasn't deductible.

Yet the new law didn't apply that same interest penalty when the life insurance covered employees. In 1998, the Clinton administration tried to close the door on this exception. Clarke/Bardes was among those lobbying to defeat this effort.

Hiring an Insider

This time around, Clark/Bardes had the help of one of the government's leading experts on the corporate-owned life insurance: Mr. Kies.

As a House Ways & Means Committee staffer in the 1980s, Mr. Kies had helped write the $50,000 limit on deductible loans against policies. After a turn as a tax lawyer and lobbyist, he returned to the government as staff chief at the Joint Tax Committee when the anonymous brown envelope arrived. By early 1998 he was back in the private sector, at a lobbying arm of what's now PricewaterhouseCoopers, and Clark/Bardes engaged him to lobby his old employer, Congress.

Mr. Kies helped lead the insurance industry's defense against the latest threat to corporate-owned life insurance. The campaign blanketed Congress with more than 170,000 letters and faxes and ran radio and newspaper ads targeting lawmakers. One of Mr. Kies's arguments was that companies borrow all the time, and their loans shouldn't be regarded as necessarily going to buy life insurance.

The Clinton administration's 1998 effort to limit tax deductions for borrowing went down to defeat. So did similar administration efforts in 1999 and 2000. Last year, Clark/Bardes gave a board seat to another Washington heavyweight, former Ways & Means Chairman Bill Archer, who had criticized janitors insurance as a tax shelter in 1995. Mr. Archer didn't return calls seeking comment.

Janitors insurance had by then mutated into managers insurance. Focusing on middle managers made it a little easier to argue that the insurance was being used to finance employee benefits, since managers were almost always eligible for benefits. While most states no longer cared what employers used life insurance for, the IRS did, to some extent. Under tax law, life insurance purchased by a corporation is supposed to have a business purpose.

Consenting Adults

Another change: Instead of keeping their life-insurance buying secret from employees, companies usually got their consent, often by telling them the insurance would help the company thrive.

That's what **Bank of America** told managers, says Cristina Deniel, who was a vice president there in 1996. She declined to let the bank buy a policy on her life after she learned the bank would keep the policy in force if employees left, tracking their deaths through the Social Security Administration. "I found that disgusting, frankly," says Ms. Deniel, who left the bank the following year.

Employers today sometimes offer managers incentives to agree to be insured. Ms. Deniel says Bank of America offered a modest payment to a charity of her choice when she died. Bank of America declines to comment on Ms. Deniel's experience.

New York Times Co. uses a different kind of carrot: It permits certain highly paid employees to use a deferred-compensation plan if they let the company make itself the beneficiary of insurance on their lives. About 200 employees have agreed to do so, a spokeswoman for the company says.

At **KeyCorp**, J. Stephen Reid readily gave consent, but changed his mind when he got a sense of how big the policy was. He learned from an annual report in 1998 that KeyCorp's life insurance on workers had a cash value of nearly $2 billion. Estimating that this translated to $8 billion or more in death benefits, he remembers thinking, "My God -- they're covering people for huge amounts of insurance, and I'm one of them."

Employers rarely tell employees how much they're covered for, but sometimes an estimate can be teased out. **Wachovia** Corp.'s life insurance has a cash "surrender" value of $6.1 billion, according to the company and its filings with the Federal Deposit Insurance Corp. That might buy death benefits of a little under $20 billion. Wachovia says it insures about 20,000 lives, implying average death benefits of $952,380. Wachovia says it can't calculate an average death benefit, but calls the estimate high.

Mr. Reid says Key Bank wouldn't tell him how big a policy it had on his life, nor what insurer provided it. An insurance salesman for 38 years, Mr. Reid, 63, calls corporate-owned life insurance "the underbelly of the insurance industry that they don't want you to know about. I know I'm insured for the rest of my life, and I don't like it."

Novel Strategy

Mr. Reid recently wrote a mystery novel, "Murder Insured," in which a firm hired a hit man to kill executives and collect death payments; the firm met its earnings targets, and officers got their bonuses. It was a spoof, of course, but Mr. Reid says he nonetheless refused to let his current employer insure his life: "I didn't want to have two ransoms on my head."

KeyCorp declines to comment on Mr. Reid's experience. A spokesman says that "employees do not pay premiums, and therefore there's no reason to disclose the details of the policy to them."

This year, insurance lobbyists again stepped up to the plate amid new rumblings in Congress about reining in corporate-owned life insurance. Rep. Gene Green, Democrat of Texas, proposed requiring employers to tell all employees, past and present, about any coverage bought on their lives since 1985. Democratic Sen. Jeff Bingaman of New Mexico began looking for cosponsors for a measure to eliminate tax benefits for policies covering employees gone for more than a year.

Clark/Bardes and insurance-industry groups led the opposition, aided by Mr. Kies's lobbying practice, which Clark/Bardes acquired earlier this year. The industry took out radio ads in the Washington area attacking proposals to curb what it called "business insurance." The proposals went nowhere.

Court Record

Recently, lawsuits have shed light on some usually hidden details of corporate-owned life insurance. After the IRS invalidated deductions for interest on loans against janitors insurance, several companies sued to reclaim the lost deductions. So far they've made little headway.

Wal-Mart is involved in two other kinds of lawsuits. First, it has sued several insurers and brokers, claiming it was misled about the risk that loans against janitors insurance might be nailed as a tax shelter. The IRS disallowed interest deductions on the retailer's janitors insurance, and the company subsequently gave up the policies. The defendants in Wal-Mart's suit, filed in Delaware state chancery court, include units of **American International Group** Inc., **Hartford Financial Services Group** Inc. and **Marsh & McLennan** Cos. They declined to comment.

Wal-Mart was itself sued by the widow of a worker whose life it had insured, Douglas Sims. A federal district court in Houston ruled that the retailer had no legal right to insure Mr. Sims. Wal-Mart is appealing.

For investors, the challenge is knowing how much life insurance might be contributing to a company's bottom line. Few companies mention life insurance in their filings. When they do, they sometimes use vague terms such as "mortality income receivable," a phrase favored by **Panera Bread** Co.

The St. Louis restaurant company collected $3 million from the deaths of employees and ex-employees last year, equal to nearly a quarter of its net income. Panera's chief financial officer, Bill Moreton, says that in 1994, when the company owned Au Bon Pain cafes, it bought policies on 4,600 employees as a "tax strategy." He says Panera borrowed against the policies and used the death benefits to repay some of the loans.

Bank of America obtains about $570 million in revenue and $196 million in net income a year from the life insurance it owns on employees and ex-employees, according to a Wall Street Journal estimate based on the bank's $9.5 billion of life insurance. That would be about 2.9% of 2001 earnings. The bank doesn't dispute the estimate.

Clark/Bardes itself got income from life-insurance on an employee in 2000. "Includes $1 million in life insurance proceeds in Other Income," says a line from a financial summary it provides investors. When asked, the insurance broker and consultant confirms that the payment was a death benefit, paid to it after an employee died in a plane crash.

Insurers Do It, Too

There's sometimes a bit more disclosure when the employer that's buying life insurance on workers is itself an insurer. If it buys the policies from a subsidiary, it has to disclose the purchases as related-party transactions.

Prudential Insurance Co. of America owns four groups of policies on workers' lives, valued at $813 million, prospectuses show. Prudential says it uses the policies to pay for employee benefits but declines to provide details. **MetLife** Inc., a big seller of corporate-owned life insurance, bought policies on "several thousand" of its own employees in 1993, 1998 and 2001. Hartford, another major provider, took out an undisclosed amount of insurance on about 800 of its own managers earlier this year.

A Des Moines, Iowa, insurer called **AmerUs Group** Co. has life insurance on most of its 1,000 or so employees. It bought them for the tax benefits, says a company official, Marty Ketelaar, who adds: "It's a profitable piece of business that also allows the employee to derive a benefit." He declines to specify the benefit. The industry is reluctant to say how big the overall market is or how fast it's growing. A.M. Best determined in 1999 that sales of corporate-owned life insurance were growing faster than sales of other kinds, but Best says it no longer keeps track of corporate life-insurance purchases. CAST Management Consultants in Los Angeles has said that in the two years through 2001, sales of new corporate-owned life insurance rose 60%. It declines to provide more recent figures.

The benefit many companies now say they're financing with life insurance is deferred-compensation, which is a kind of giant savings plan for highly paid executives. But even if an employer buys bales of life insurance in connection with its deferred-comp plans, there's no guarantee the money will remain in the policies.

Consider what happened at Enron Corp. It took out $500 million of life insurance on employees, which it indicated was to finance its deferred-compensation programs and executive pensions. But Enron borrowed most of the assets within the policies, documents from bankruptcy court filings show, leaving it roughly $145 million short of what it owed its executives for deferred-compensation benefits alone.

Now the policies are assets in Enron's bankruptcy proceedings. The total death benefits on the policies, before paying off policy loans, could reach $2 billion. Waiting in line for this money are Enron creditors, to whom Enron executives are worth more dead than alive.

Wanted: Dead or Alive

Employers have continued to buy ever-greater amounts of life insurance on employees, eluding lawmakers' crackdowns again and again.

	KEY MAN INSURANCE	JANITORS INSURANCE	MANAGERS INSURANCE
Employers buy insurance on	Top executives	Rank-and-file workers	Middle managers
When	1980s* to present	1987 to 1996	1996 to present
Government crackdown	1986: Congress limits interest deduction for a single-policy loan to $50,000	1996: Congress phases out interest deduction for policy loans	1997: To prevent lenders from taking out policies on mortgage holders and depositors, Congress limits deduction on loans used to buy life insurance on them; it exempts policies on employees. 1998-2000: Congress seeks to rescind the 1997 exemption
Employer response	Companies instead buy thousands of smaller polcies on rank-and-file workers	Companies instead borrow money from other sources to buy life insurance on managers	Employers continue to buy even more life insurance on employees
Ostensible use of insurance	To protect company from untimely deaths of key executives	To pay for retiree medical benefits	To pay for retiree medical benefits and executive deferred- compensation programs
Financial benefit to employer (for all types)	Money in policies grows tax-free and boosts income. The combination of tax-free returns and deductions for interest on loans used to buy life insurance effectively produces attractive returns.		

*Employers purchased smaller amounts of key man insurance prior to the 1980s.

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