

## **Critical Questions of Due Diligence in Annuity-Based Structured Settlements**

*By Richard G. Halpern*

Although annuity-based structured settlements have accounted for more than 95% of all structured settlements, recent developments have resulted in changes that may have profound implications for plaintiffs counsel attempting due diligence in deciding whether to recommend a particular proposal. In this installment of "Direct Examination," we address the critical questions in determining the proper course of action.

### **Q: How have plaintiffs counsel evaluated the security of proposed annuities in the past?**

A: Before 1990, plaintiffs counsel concerned about the safety of structured settlement annuities would usually consult the Bests rating (Alfred M. Best & Company, Oldwick, NJ) of the annuity issuer in question. Many attorneys would accept only A+ ratings, but the majority of attorneys (as well as courts in infant and incompetent cases) would accept annuities with a Bests rating of A or higher. The late '80s and early '90s saw the use of additional rating services for confirmation of safety, including Standard & Poors, Moodys, and Duff and Phelps.

### **Q: Did this constitute due diligence?**

A: Certainly. Prior to 1991, nothing had occurred that would cause a logical person to question the approach. Until the failure of Executive Life, reliance on the ratings services as an indicator of future stability was a method that had proven effective over the years.

### **Q: Are the financial ratings services a valid basis for determining the future financial stability of annuity issuers?**

A: No, because the recent failures of highly-rated annuity companies have demonstrated that the ratings are not an accurate measure of future stability.

In May of 1989, Bests gave the Executive Life Companies their highest rating of A+, and Standard & Poors gave them their highest rating of AAA (Bests introduced the A++ as their highest rating sometime in 1992). Yet two years later, in April of 1991, the Companies were seized by their respective state insurance commissioners.

Confederation Life was seized in August of 1994 and yet, as recently as February of 1991, it had received Bests highest rating (A+), the highest rating from Duff and Phelps (AAA), and the highest rating from Standard & Poors (AAA).

Although not an issuer of structured settlement annuities, Mutual Benefit Lifes ratings history is especially significant. A company known for conservatism that did not deal in junk bonds or risky products, Mutual Benefit Life was seized by the commissioner in May of 1991. Just one year earlier, in May of 1990, it had received the highest ratings from Bests (A+) and Standard & Poors (AAA).

### **Q: Does this mean that all life insurance companies are in jeopardy?**

A: No. Almost certainly, the majority of companies will continue to prosper. But of equal certainty is the likelihood that some companies will collapse in the near and long term, like Executive Life, Confederation Life, and Mutual Benefit Life. The financial ratings services, however, cannot be relied upon to alert plaintiffs as to which annuity issuers are riskier than the others, as the ratings services themselves have stated.

### **Q: Is there any reason to believe that the investment practices of insurance companies place them at risks for future failures?**

A: Possibly. An article in the September 29, 1995 Wall Street Journal entitled "Life Insurers Moving into Riskier Bonds, Ratings Agency Says," discusses a report released by Moodys Investors Services on the investment behavior of life insurance companies. It notes that:

"Below-investment-grade holdings topped 80% in 1990," which may have laid the groundwork for the largest number of regulatory agency seizures of highly-rated annuity issuers in history the following year. The article went on to say that the pattern has continued:

"The report said while below-investment-grade bonds as a percentage of capital remained flat last year, at about 46%, a few large companies allocated a greater portion of cash flow to such investments, and exposure is expected to rise this year."

This would result, said the Journal, in "potentially weak ratings in the medium to long term," according to a Moodys analyst. In other words, the companies were likely to be less stable in the future, a fact not necessarily predicted by their current ratings.

**Q: How does the insurance industry itself view the risks of annuity-based structured settlements?**

A: The Confederation Life liquidation is revealing.

As part of the rehabilitation plan, the rehabilitators and insurance commissioners decided to sell all the assets of Confederation Life Insurance and Annuity Company (CLIAC). The purchaser was Aetna Life Insurance and Annuity Company in Hartford (ALIAC). An October 2, 1995 news release issued by the rehabilitator said that:

"This transaction fulfills my pledge to protect policy values and benefits, and to ensure the fair treatment of CLIAC policy holders, said Commissioner Oxendine."

An article published a month earlier in The National Law Journal told another part of the story. Entitled "Winners Caught in a Vise," by Gail Diane Cox, it revealed the following:

"...Georgia's commissioner of insurance went to court this summer with a rehabilitation plan... The plan -- which calls for Aetna Life Insurance and Annuity Company to purchase all of CLIACs business except the structured settlement contracts -- touched off anger among annuitants who suspected Aetna was cherry picking. Their attorneys, however, said insurance officials persuaded them that the alternative was liquidation... The state regulators--and so far we are just trusting that they are telling us the truth--made the case that if we filed objections and caused delay, Aetna would walk."

An item appeared in Aetnas structured settlement newsletter (Cutting Aedge News) on October 3, 1995, one day after the rehabilitators news release. It was entitled "ALIAC Withdraws from Structured Settlement Business Effective October 13, 1995." The opening paragraph of this communication specifies Aetnas reason for taking this drastic move. It stated:

"This decision was driven by the significant capital investment required for this line... and by concerns about the long-tailed liabilities unique to structured settlement annuities."

Thus Aetna, a major force in both the structured settlement and liability insurance industries, took the position that it was withdrawing from the structured settlement industry as an annuity issuer because this particular line of business entailed unacceptable risks. It had concluded that it was not prudent to continue to issue structured settlements directly, nor was it safe to purchase the structured settlement obligations that were held by Confederation Life Insurance and Annuity Company.

In late 1992, Allstate introduced their own structured settlement trust, which is a structured settlement funded with U.S. Government obligations instead of annuities. Because of the nature of this transaction,

they submitted a request to the Securities and Exchange Commission on September 30, 1991, for what is commonly referred to as a no-action letter, stating that the product they were selling was not a security requiring registration pursuant to the various securities regulations. The request was written by Allstates counsel and sent to the office of Chief Counsel, Division of Corporate Finance, at the Securities and Exchange Commission in Washington, D.C.

The procedure requires a written request for a no-action letter, supported by significant factual detail as to why the ruling is necessary and why it is justified. The SEC usually replies with a list of specific questions; the applicant then answers all the questions, and, if the SEC is satisfied with the response, they then issue the requested letter. Allstate followed this procedure, and received its letter.

In doing so, they were truthful and candid, as is required by the agency. Section A of Allstates letter dated September 30, 1991, describes the purpose of the trust:

"...It is well known that recently some of the largest and sound corporations, and even established and supposedly sound insurance companies, have quickly and unexpectedly become insolvent."

The following paragraph goes on to say that "Injured individuals and their families (and society) should not, and will not have to, bear the business risks that jeopardize the ability of non-governmental defendants to fulfill their obligations many years into the future."

Subsequent to this September 30, 1991 submission, the SEC responded with a series of questions. Allstates counsel responded to the SEC via letter on July 22, 1992. One of the questions asked was: "Why doesn't Allstate issue annuities to settling plaintiffs instead of going to the trouble to set up the trust?" Allstates answer to the SEC:

"Allstate is the second largest writer of annuity-funded structured settlements in the United States. It has been perceived that a more safe and secure alternative to conventional structured settlement vehicles is needed. The trustees desire to create the trust to provide structured settlements that are backed by government securities but which also offer flexible payment options...

"In recognition of the fact that no annuity, no matter how strong the issuer, is as safe and secure as government securities, the trust will not purchase annuities as funding assets, but will purchase only government securities. The purpose of the trust is to offer structured settlement arrangements that are second to none in terms of the safety offered to settling claimants. Because many claimants are severely injured, with little chance of ever holding gainful employment, they will have heavy ongoing medical expenses for the remainder of their lives. For such settling claimants, any possibility of not receiving the benefit payments specified in their settlement agreements is unacceptable. These are the claimants for whom the trust is designed."

**Q: Has the insurance industry's recognition of increased risks involved with annuity-based settlements been communicated by them to plaintiffs counsel?**

A: Not to date. For example, at the exact same time that Allstates attorneys were making the above representation to the SEC, Allstate had national representation by structured settlement brokers who told plaintiffs attorneys how safe and secure Allstate annuities were, playing heavily on their ratings from the various ratings services.

**Q: Given the lack of information from the annuity issuers themselves, and the inadequacies of the ratings services, how have plaintiffs counsel attempted to exercise due diligence in the recommendation of annuity-based structured settlements to injured plaintiffs?**

A: Since the annuity failures of the early '90s, most attorneys who are still doing annuity-based structured settlements have started demanding higher quality issuers. The conventional wisdom has been that the big three were Prudential, Metropolitan and New York Life. As this is written, Prudential

no longer receives the highest ratings from even one of the major rating services. Metropolitan has seen its ratings decline, and is on the watch list of more than one rating service for future downgrading. Only New York Life, who just re-entered the structured settlement industry in 1994, still has pristine ratings. But clearly, pristine ratings are no longer a reliable indicator. History has proven that due diligence simply cannot be achieved by using the ratings services.

**Q: Does this compel the conclusion that there is no way a plaintiffs counsel can exercise due diligence while recommending an annuity-based structured settlement, and that such an attorney is per se placing the plaintiff at risk while exposing himself to potential malpractice?**

A: That issue has not been settled at this time. Right now, this is a question that each plaintiffs counsel must consider individually. Fortunately, there are excellent alternatives to annuity-based structured settlements, so concerned attorneys have acceptable options that do meet the due diligence standards.

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