

**BROAD-BASED, LEVERAGED CORPORATE OWNED
LIFE INSURANCE LITIGATION: THE POLICYHOLDER'S PERSPECTIVE**
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Corporate owned life insurance (“COLI”) has long been a staple of American business. It is a risk management and investment tool under which a corporate employer is the policyholder, premium payer, and beneficiary of life insurance policies covering the lives of its officers and employees.¹ From the risk management perspective, COLI plans provide a means to insure against the loss of key employees. As an investment tool, the plans offer corporations the ability to: (i) deduct interest paid against policy-based loans; and (ii) collect death benefits tax-free.²

One of the most widely recognized forms of corporate owned life insurance involves policies covering the lives of a company’s essential personnel. This type of COLI, dubbed “key man” insurance, has been utilized for many years.³

In 1986, certain amendments to the Internal Revenue Code (“IRC”) restricted the deductibility of key man insurance.⁴ These changes gave rise to a new investment vehicle known as broad-based, leveraged corporate owned life insurance.

Typically, key man policies are purchased on a relatively small number of lives, require large premium payments and pay very high death benefits.⁵ Broad-based, leveraged COLI, on the other hand, was designed to cover virtually all members of a given workforce, and do so at much lower premium and benefit levels.⁶ The underlying purpose of broad-based, leveraged COLI was to aggregate the large number of insureds to provide greater tax benefits than those that could be realized from smaller key man pools. At the same time, the smaller individual policy levels avoided the deductibility caps implemented by the 1986 IRC amendments.⁷

¹ *In re C.M. Holdings, Inc.*, 254 B.R. 578, 586 (Bankr D. Del. 2000), *aff’d*, 301 F.3d 96 (3d Cir. 2002).

² *Id.*; *Insurance Coverage Disputes* (Law Journal Press), Release 13, §12.05.

³ *Id.*

⁴ *Insurance Coverage Disputes* (Law Journal Press), Release 13, §12.05.

⁵ *Id.*

⁶ *Id.*

⁷ *Id.*

Broad-based, leveraged COLI plans were designed to remain in place for thirty to fifty years. In theory, the tax arbitrage resulting from a plan's operation, would generate hundreds of millions of dollars in after-tax profits for the corporate policyholder. Such funds could then be utilized by the policyholder to offset the rising cost of employee retirement and benefit plans.

In the light of its promised benefits, broad-based leveraged COLI became very popular among large corporations. Undocumented estimates suggest such plans were purchased by nearly half of the Fortune 500.⁸

Recently, the broad-based, leveraged COLI bubble has burst. Specifically, since 1999, the Internal Revenue Service ("IRS") has prevailed in three separate trials against corporate taxpayers who had claimed millions in COLI-related deductions.⁹ In each case, the broad-based, leveraged program at issue was found to be a tax sham. As result of these judicial determinations, myriad corporations have been forced to unwind their programs and settle their COLI-related deduction disputes with the IRS.¹⁰

While COLI-related litigation between corporate policyholders and the IRS has been active since the late 1990s, it is only within the last eighteen months that policyholders' claims against the purveyors of broad-based, leveraged COLI plans have entered the national stage. As of this writing, two cases are in active litigation,¹¹ with more expected in the coming years.

⁸ *Id.*

⁹ *Winn-Dixie Stores v. C.I.R.*, 113 T.C. 54 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001); *In re C.M. Holdings, Inc.*, 254 B.R. 578 (Bankr D. Del. 2000), *aff'd*, 301 F.3d 96 (3d Cir. 2002); *AEP, Inc. v. United States*, 136 F.Supp. 2d 762 (S.D. Ohio 2001), *aff'd*, 326 F.3d 737 (6th Cir. 2003).

¹⁰ A common misperception that accompanied the IRS attacks was that corporations were using broad-based, leveraged COLI to benefit from the deaths of their employees. In actuality, the policies were designed to be "mortality neutral." That is, the longer the insured employees lived, the more profitable the plans became. Notwithstanding this fact the public has come to view broad-based, leveraged COLI with a jaundiced eye. The general misunderstanding has been exacerbated by the media which has taken to referring to broad-based, leveraged COLI plans as "janitor's insurance" and "dead peasant policies."

¹¹ *Wal-Mart Stores, Inc. v. AIG Life Insurance Co., et al.*, filed in New Castle County, Delaware in September 2002; and *Eastman Kodak Company v. Hartford Life Insurance Co., et al.*, filed in the Superior Court of New Jersey, Law Division, Morris County in March 2003.

A comprehensive analysis of these highly complicated, tax-driven investment vehicles and the claims they have spawned is beyond the scope of this article. Instead, the following discussion provides a brief synopsis of the history and structure of the failed broad-based, leveraged COLI plans and summarizes potential causes of action available to the policyholders who purchased them.

I. BACKGROUND

The COLI plans at issue today trace their roots to the mid-1980s.¹² Specifically, in 1986, there were two IRC amendments that impacted the investment value of corporate owned life insurance. One change limited deductibility under such plans to \$50,000 per insured. The second 1986 amendment capped the premiums that could be charged for corporate owned life insurance policies. While the former change reduced the investment value of key man insurance, the latter threatened to convert life insurance-based plans to “modified endowment contracts,” which do not enjoy the same favorable tax treatment.

In the wake of the 1986 amendments, insurance industry entrepreneurs set out to create a corporate owned life insurance plan that would remain financially viable in the face of the new IRC rules. Their goal was to develop a COLI product that would benefit large corporations by offering instantaneous policy value that would exceed the premiums paid at the end of the first year. If the investment vehicle could qualify as life insurance, it would provide the corporate policyholder with favorable tax benefits, including: i) tax-deductible interest payments generated by policy-based loans; ii) tax-deferred increases in policy value, also known as “inside build-up;” and iii) tax-exempt policy proceeds upon the death of an insured. In theory, this new COLI product would generate immediate positive cash flow.

Three major obstacles stood in the way of the post-1986 COLI plans. First, since each policy could only generate \$50,000 in deductions, the plans had to cover a large number, or “broad base,” of individuals. Second, to avoid becoming modified endowment contracts, the premium levels had to be very carefully regulated. Finally, in order to allow the corporate policyholder to deduct interest on policy-based loans, premiums could be paid by indebtedness in only three of the first seven years of a given plan.¹³ The “leveraged” portion of the name refers to the sophisticated borrowing features designed to comply with this requirement.

The designers of the post-1986 plans attempted to address each of the foregoing issues. The result was an investment vehicle that has been described, *inter alia*, as “a fixed premium,

¹² A detailed history of the development of broad-based, leveraged corporate owned life insurance was provided by Judge Schwartz in his *CM Holdings* opinion. *See*, 254 B.R. at 586-88.

¹³ This requirement was mandated by IRC §264, which essentially disallows interest deductions on amounts that are systematically borrowed against an insurance policy to pay the premiums. However, if in no part of four of the first seven years of a given plan the premiums are paid by means of indebtedness, the policy loan deductions are permissible. This carve out has become known as the “Four Out of Seven Safe Harbor.”

increasing death benefit whole life contract.”¹⁴ Its more common name is: broad-based, leveraged corporate owned life insurance.

II. MECHANICS

In order to achieve optimal profitability, broad-based, leveraged COLI plans required a large number of potential insureds. Designers solved this problem by marketing their creation to corporations with large workforces and vast revenues.

Yet, enlisting clients with thousands of employees and a healthy appetite for tax deductions was only the beginning. For, after hand-picking their corporate clientele, the COLI designers had to develop a way to ride mathematical herd over each customers’ extensive pool of participating insureds. Specifically, each of the thousands of policies that comprised a given broad-based plan required careful regulation to produce exactly \$50,000 in deductions. At the same time, each individual policy premium had to be monitored so as not to exceed the allowable life insurance limits.

The solution to these problems was found in sophisticated computer programs. Specifically, the COLI entrepreneurs developed software that simultaneously calculated the maximum premiums that could be charged and deductions that could be claimed under a given plan. Because these computer programs were indispensable to the profitable operation of the broad-based, leveraged COLI plans, the software became a cash cow for its designers.

Once the logistical problems were solved, financing issues came to the fore. The obvious impact of purchasing life insurance on thousands of employees, is paying the premiums for thousands of policies. Consequently, the COLI designers had to devise a means to offset premium costs. This task was complicated by IRC § 264’s mandate that in four of the first seven years of a given plan, premiums could not be paid by way of indebtedness. Stated another way, a corporate policyholder could pay only three years of premiums with loans against the plan.

As the name implies, the designers of the post-1986 COLI plans attempted to minimize the policyholders’ outlay through leveraging. In furtherance of this goal they employed “netting transactions,” “loading dividends” and “partial policy withdrawals.”

Essentially, netting transactions are the simultaneous exchange of premium payments for policy loans. Their practical effect is to allow the COLI carrier to “book” very large premium payments without requiring the corporate policyholder to front actual cash. Netting transactions were blatantly utilized in the first three years of a given COLI plan, when loans could be used to pay policy premiums.

In the first three years of a given plan, netting transactions ensured that the only out-of-pocket costs actually paid by the policyholder were the “expense charges” associated with the

¹⁴ CM Holdings, 254 B.R. at 591.

plans. A typical expense charge could account for up to 5% of a given plan's annual "booked" premium.¹⁵ By way of perspective, it was not uncommon for an annual booked premium to approach, or exceed, \$100 million. Consequently, even with the netting transactions in place, corporate policyholders were required to make annual, multi-million dollar cash payments into their broad-based, leveraged COLI plans.

Netting transactions were employed more surreptitiously in years four through seven of the typical plan. In those years, when IRC §264 forbade the use of loans to fund premium payments, the COLI plans manufactured refunds to achieve the same goal. Since refunds could not appear to be a form of indebtedness, they were dressed up to resemble the return of expense charge overpayments. Specifically, in the fourth through seventh years of a given plan, the expense charge that had been roughly 5% of premium in years one through three, skyrocketed to approximately 95% of premium. After the "actual expenses" were determined, the "expense charge overpayment" was immediately returned to the policyholder. Thanks to the sophisticated computer programs discussed above, all expense charge payments, reconciliations and refunds were accomplished via simultaneous netting transactions on the first day of each new policy year.

"Loading dividends" and "partial policy withdrawals" were the devices through which expense overpayments were returned to policyholders. Both were designed so that, in years four through seven of a given plan, full premium payments were "booked" but only the 5% expense charge was actually paid by the corporate policyholder.

After seven years, the typical broad-based, leveraged COLI plan was designed to become essentially self-funding. From that point, until their expiration decades later, the plans promised extensive tax benefits for no additional cash outlay.

Highly detailed discussions of COLI plan mechanics can be found in the trilogy of tax court cases discussed, *supra*.¹⁶ For present purposes, however, the following example demonstrates how a \$100M loan to pay COLI premiums, at 10% interest, generates a positive \$3,600,000 annual cash flow, where the interest credited on the account value build-up is 9.6% and the corporate tax rate is 40%:

¹⁵ The composition of any given expense charge is a matter of some dispute. The purveyors of COLI plans assert that expenses represented actual costs of insurance, such as state and federal premium taxes and administrative fees. The purchasers of the plans, on the other hand, aver that "expense charges" included clandestine profits to plan designers, underwriters and brokers. It is expected that the true nature of the expense charges will be illuminated as the pending corporate policyholder lawsuits enter the discovery phase.

¹⁶ *Winn-Dixie Stores v. C.I.R.*, 113 T.C. 54 (1999), *aff'd*, 254 F.3d 1313 (11th Cir. 2001); *in re C.M. Holdings, Inc.*, 254 B.R. 578 (Bankr D. Del. 2000), *aff'd*, 301 F.3d 96 (3d Cir. (continued).(continued).(continued).

Column A		Column B		Column C		
Assumptions:		Calculation of Loan Interest Expense:		Calculation of Borrowed Cash Value Growth:		
Cumulative Loan Amount:	\$100,000,000	Cumulative Loan Amount:	\$100,000,000	Cumulative Loan Amount:	\$100,000,000	
Loan Interest Rate:	10%	Loan Interest Rate:	10%	Borrowed Cash Value Crediting Rate:	9.6%	
Borrowed Cash Calue Crediting Rate:	9.6%	Pre-Tax Loan Interest:	\$10,000,000	Cash Value Growth:	\$9,600,000	
Corporate Tax Bracket:	40%	Less Tax Savings @ 40%	\$4,000,000	Taxes Due:	-0-	
		After-Tax Cost:	\$6,000,000	Net Cash Value Growth:	\$9,600,000	
Net Benefit of Loan Transaction			(\$6,000,000)		\$9,600,000	\$3,600,000

Column A of this illustration enumerates the basic assumptions: The policyholder borrows \$100 million from the carrier to pay one annual premium on a COLI plan. The policyholder pays 10% interest on that loan. The policyholder will be credited with \$100 million premium payment to the carrier. That premium payment, in turn, will give rise to an interest charge of 9.6% which is credited to the plan’s “inside buildup.” The 0.4% difference between the 10% interest the policyholder pays and the 9.6% interest credited to the plan represents the “interest spread” which is retained, as profit, by the carrier. Finally, Column A notes that the corporate policyholder is taxed at a rate of 40%.

Column B of the illustration demonstrates the calculation of loan interest expense. Again, the full loan amount is \$100 million and the interest rate is 10%. Consequently, the first year interest payment is \$10 million. In the 40% tax bracket, the corporate policyholder’s after tax cost is \$6 million. More explicitly, the policyholder pays \$100 million, borrows back \$100 million, and incurs 10% interest, which requires a \$10 million payment the first year. The policyholder then gets to deduct its \$10 million payment for a total after tax cost of \$6 million.

2002); *AEP, Inc. v. United States*, 136 F.Supp. 2d 762 (S.D. Ohio 2001), *aff’d*, 326 F.3d 737 (6th Cir. 2003).

Column C of the illustration calculates the borrowed cash value growth. Essentially, the \$100 million loan is a bookkeeping entry with the COLI carrier, and it is growing at an annual rate of 9.6%. Practically speaking, in the first year the \$100 million loan will have earned \$9.6 million in interest. That \$9.6 million of earned-interest income is not taxed because it is associated with life insurance.

In sum, the corporate policyholder in the foregoing illustration will have earned \$9.6 million through the “inside buildup” of its plan. Because the policyholder’s out-of-pocket cost was \$6 million in interest expenses, the COLI arbitrage gave rise to \$3.6 million in positive net income for that one year.

Typically, broad-based, leveraged COLI plans were designed to operate over a period of thirty years or more. Moreover, the \$100 million first-year premium illustrated above was not unusual in this type of program. In the light of these two facts, it is easy to see how an annual tax savings of just \$3.6 million could easily grow into tens or hundreds of millions in savings across the anticipated life of a given COLI plan.

Notably, the policyholders were not the only parties to reap the long-term benefits of broad-based, leveraged COLI. Rather, as indicated below, the designers, underwriters, brokers and administrators of broad-based, leveraged COLI were all extremely well compensated for their participation in the plans.

III. THE PROSPECTIVE DEFENDANTS

There are four basic players in the broad-based, leveraged COLI game: entrepreneurs; carriers; brokers; and administrators. From the policyholder’s perspective, each participant has become a potential defendant.

Each player had a specific role in the creation and operation of a given plan. First, the entrepreneurs designed the broad-based, leveraged COLI blueprint. Second, insurance carriers “papered” the programs, *i.e.* issued the life insurance around which the investment vehicle was built. Third, insurance brokers promoted and sold the plans. Finally, in order to achieve maximum performance, the plans were closely administered. This latter function was performed either by the brokers themselves, by “administrative” agents of the COLI carriers, or by some combination of the two.

Whatever their role, the individuals and entities involved in broad-based, leverage COLI were motivated by one goal: to make large sums of money. Though the plan designers, underwriters, brokers and administrators each achieved this objective, they did so at the direct expense of their corporate clients.

IV. CHALLENGES TO BROAD-BASED, LEVERAGED COLI

Due the efforts of the “players” enumerated above, broad-based, leveraged COLI plans were sold with great success in the late 1980s and early 1990s. To date, while undocumented

estimates suggest that up to half of the Fortune 500 purchased such plans, the exact number of once-active programs remains unknown.¹⁷ Nevertheless, at least one court has noted that by the turn of the century, the IRS had identified some 85 plans, which collectively represented a potential tax liability of \$6 billion.¹⁸

Unfortunately, while the post-1986 COLI plans were still in their infancy, the wheels came off the broad-based, leveraged wagon. Specifically, in the late 1990s, two major attacks were launched against the plans: one by the IRS; the other by the corporate employees who had been insured under the plans.

A. Sham Transaction Challenges

The first attack came in the form of lawsuits filed by the IRS. The specific aim of these suits was to deny, and recover, the extensive deductions that corporate policyholders had taken in connection with their broad-based, leveraged COLI plans. In a trilogy of decisions issued in 1999, 2000 and 2001, three separate federal district courts sided with the IRS and determined that the plans before them constituted tax shams.¹⁹ Each decision was subsequently affirmed on appeal.²⁰

Though the broad-based, leveraged COLI plans at issue in the three tax court cases were not identical, the mechanics of each mirrored the illustration provided in Part II, *supra*. Each plan was designed to achieve “mortality neutrality,” each utilized very high loan interest rates to maximize profitability, and each relied upon “loading dividends” or “partial policy withdrawals” to offset premium payments. After conducting in-depth reviews of the plans at issue, with a particular emphasis on the foregoing features, the three separate courts unanimously concluded that broad-based, leveraged COLI was a tax sham.

In short, the IRS’ sham transaction challenges effectively killed broad-based, leveraged COLI.²¹ From that point forward, corporate policyholders were forced to unwind their programs and settle their deduction disputes with the IRS.

¹⁷ *Insurance Coverage Disputes* (Law Journal Press), Release 13, §12.05.

¹⁸ *CM Holdings* 254 B.R. 582, n. 1.

¹⁹ *Winn-Dixie Stores v. C.I.R.*, 113 T.C. 54 (1999), *aff’d*, 254 F.3d 1313 (11th Cir. 2001); *in re C.M. Holdings, Inc.*, 254 B.R. 578 (Bankr D. Del. 2000), *aff’d*, 301 F.3d 96 (3d Cir. 2002); *AEP, Inc. v. United States*, 136 F.Supp. 2d 762 (S.D. Ohio 2001), *aff’d*, 326 F.3d 737 (6th Cir. 2003); *Dow Chemical Company v. United States*, 250 F.Supp. 2d 748 (E.D. Mich. 2003).

²⁰ *Id.*

²¹ Just last year, in the fourth COLI-related tax trial, one policyholder actually prevailed against the IRS. See *Dow Chemical Company v. United States*, 250 F.Supp. 2d 748 (E.D. Mich. 2003). The *Dow Chemical* COLI plan was unique and, therefore, distinguishable from the plans at issue in *Winn-Dixie*, *CM Holdings* and *AEP*. Moreover, *Dow* is presently on appeal to the Sixth Circuit, the court that sided with the IRS in *AEP* shortly (continued).(continued).(continued).

B. Insurable Interest Challenges

The second wave of attack against broad-based, leveraged corporate owned life insurance has come in the form of employee lawsuits. Specifically, individuals, and the estates of decedents, whose lives had been insured under broad-based, leveraged COLI have sued their former employers for implementing the plans. The gravamen of these complaints is that the corporate policyholders lacked an insurable interest in the lives of the employees around whom the programs were built. As damages, plaintiffs seek to recover from their employers all death benefits generated by the plans.

To date, “insurable interest” lawsuits have met with mixed results. By way of example, in September of 2003, a federal district court in Oklahoma granted summary judgment in favor of a corporate policyholder.²² Earlier this year, however, the Fifth Circuit Court of Appeals affirmed a decision out of the Southern District of Texas which found in favor of the employee-insureds.²³

In view of the conflicting decisions now on file, the future of insurable interest litigation is unclear. If these suits proliferate and plaintiffs are successful, however, the cost to corporate policyholders could be enormous. Indeed, if corporate policyholders are forced to pay death benefits to their insured employees, the financial impact of such payments could easily dwarf the lost deduction damages already sustained.

V. POLICYHOLDERS’ DAMAGES

From the corporate policyholder perspective, failed broad-based, leveraged COLI plans have resulted in to two basic types of damages: (i) “benefit of the bargain” based losses; and (ii) “out-of-pocket” related costs. In a nutshell, the former refers to the promised tax deductions that never materialized, while the latter describes monies paid into the plans.

In terms of composition, lost deduction damages are readily visible. Out-of-pocket costs, on the other hand, require some illumination.

Typically, corporate policyholders made three types of pay-ins to their broad-based, leveraged COLI programs: (i) expense charges affiliated with premiums; (ii) loan spreads which are retained by carriers; and (iii) administrative fees paid to brokers/administrators. While not

after *Dow* was decided. Consequently, *Dow’s* ultimate impact on the broad-based, leveraged COLI dispute remains to be seen.

²² *Tillman v. Camelot Music, Inc.*, No. 02-CV-0761-EA(J) (N.D. Okla. Sept. 29, 2003).

²³ *Mayo, et al. v. Hartford Life Ins. Co., et al.*, 2004 WL 14654, ___ F.3d ___ (5th Cir. 2004).

exhaustive, these categories also describe the major components of the prospective defendants' profits.

By design, broad-based, leveraged COLI plans promised to convert multi-million dollar investments into multi-million dollar tax deductions. Regardless of the theory under which a given suit proceeds, therefore, policyholder damages reach well into eight figures.

VI. POLICYHOLDERS' RECOURSE

Just as damages fall into two categories, so too, do a policyholder's potential legal claims. Specifically, the failure of broad-based, leveraged COLI has spawned both fault and non-fault based causes of action.

"Fault based" claims essentially allege that the designers, underwriters, brokers and administrators of broad-based, leveraged COLI plans were aware of, but failed to disclose, the fatal flaws in their programs. Examples of such causes of action include: civil conspiracy; fraud; breach of fiduciary duty; negligence; and negligent misrepresentation.

"Non-fault based" claims, in contrast, are based on the theory that all parties to the broad-based, leveraged COLI plans believed that such plans were legitimate investment vehicles that would provide long-lasting economic benefits to all involved. These claims, which include mutual mistake, frustration of purpose, impossibility of performance and unjust enrichment, turn upon the frustrating effect that judicial and regulatory determinations have had on broad-based, leveraged COLI plans.

As of this writing, the existing corporate policyholder lawsuits are at the pleading stage. Consequently, the strength of each potential cause of action remains untested.

VII. CONCLUSION

As indicated above, policyholder driven, broad-based, leveraged COLI litigation is in its infancy. Nevertheless, over the coming months, additional lawsuits can be expected to materialize as corporations seek to recover the millions of dollars in losses engendered by the failure of these programs. With so much money at stake, it will come as no surprise if corporate policyholder lawsuits ultimately live longer than the COLI programs from which they arise.