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Life insurance policies added to IFDA fund losses

State agency fines, revokes license of agent

By BRUCE RUSHTON
THE STATE JOURNAL-REGISTER
Posted Jun 15, 2009 @ 11:56 PM

Rather than risk getting no money at all, the trustee for a troubled pre-need funeral fund is surrendering life insurance policies for cash value, worsening already steep losses in a fund that's supposed to pay for funerals for more than 40,000 people in Illinois.

At the heart of the fire sale, say funeral directors, are determinations that the policies should never have been purchased by the Illinois Funeral Directors Association because it had no insurable interest in the lives of insured funeral home directors.

In issuing a $100,000 fine and revoking the insurance license of Edward Schainker, a Merrill Lynch financial adviser and insurance broker who sold policies to IFDA, the Illinois Division of Insurance last month ruled that sale of the policies violated state law because the association had no insurable interest. The policies were billed as "key man" policies, which are typically used to insure the lives of important employees, such as top-producing salesmen, say funeral directors who are suing the association, Merrill Lynch and others.

But more than 100 funeral home directors whose lives are insured have no relationship to the association except for being members. Schainker offered free $25,000 life insurance policies to funeral home directors who allowed their lives to be insured, the plaintiffs say.

Phillip Stern, Schainker's lawyer, said his client has violated no state insurance or securities laws. It's up to insurance companies to find insurable interests when policies are sold, he said.

"Underwriters are responsible for determining insurable interests, so apparently, they concluded that there is, in fact, an insurable interest," Stern said.

The lack of insurable interest might allow insurance companies to deny death benefits, the plaintiffs say. And so Merrill Lynch Trust Co., which is now trustee for the fund, has been surrendering policies and incurring millions of dollars in penalties and taxes on a fund that was supposed to be tax exempt, the plaintiffs allege.

Funeral home directors who are suing IFDA and Merrill Lynch say the policies should have been liquidated long ago, when the fund contained more money, so the sting of taxes and penalties would not have been as severe. At the end of 2007, for example, the cash-surrender value of the policies stood at $173 million, the plaintiffs say. Now, they say, the cash-surrender value is about $100 million. The policies, at least on paper, have death benefits totaling $357 million.

For years, a strong stock market helped hide losses, the plaintiffs say. Once the market tanked, it became clear that monies paid by new pre-need funeral customers were funding funerals for previous contract purchasers, say plaintiffs who compare the fund's operation to a Ponzi scheme.

Payouts from life insurance were supposed to create an endowment worth hundreds of millions of dollars to cover funeral costs, the plaintiffs say, but there was one insurmountable problem: Few funeral directors were dying. Between 2000 and 2006, the plaintiffs say, there were just two years in which the trust received proceeds from life insurance policies that paid out slightly less than $4.6 million. The average insured funeral home director is in his mid-60s and was considerably younger when the association bought the policies, the plaintiffs say. The average pre-need funeral customer dies between seven and nine years after purchasing services.

Schainker, Merrill Lynch and other insurance companies have collected millions of dollars in commissions, fees and premiums, the plaintiffs say. Commissions and fees consumed 3.5 percent of the fund each year, so it had to make at least that much to break even. Merrill Lynch and a half-dozen other firms that sold policies to IFDA collected more than $90 million in premiums, according to the lawsuit. The plaintiffs don't say how much the policies have paid out since 1986, when IFDA began purchasing them. But they indicate the amount has been paltry.

"(B)ut for a few small policies that were paid years ago, the … plan to endow the pre-need trust with the death benefits of these insurance policies, worth over $357 million in death benefits, has failed," the plaintiffs say.

Bruce Rushton can be reached at 788-1542.