Fallen Soldiers' Families Denied Cash Payout as Insurers Profit

Cindy Lohman holds a photo of her late son, Ryan, on the grounds of Monocacy National Battlefield in Frederick, Maryland, U.S., on Friday, July 9, 2010. Ryan was a U.S. Army sergeant, killed by a bomb while serving in Afghanistan in 2008. Photographer: Bill Cramer/Bloomberg Markets via Bloomberg

By David Evans

July 28 (Bloomberg) -- The package arrived at Cindy Lohman's home in Great Mills, Maryland, just two weeks after she learned that her son, Ryan, a 24-year-old Army sergeant, had been killed by a bomb in Afghanistan. It was a thick, 9-inch-by- 12-inch envelope from Prudential Financial Inc., which handles life insurance for the Department of Veterans Affairs.

Inside was a letter from Prudential about Ryan's $400,000 policy. And there was something else, which looked like a checkbook. The letter told Lohman that the full amount of her payout would be placed in a convenient interest-bearing account, allowing her time to decide how to use the benefit.

"You can hold the money in the account for safekeeping for as long as you like," the letter said. In tiny print, in a disclaimer that Lohman says she didn't notice, Prudential disclosed that what it called its Alliance Account was not guaranteed by the Federal Deposit Insurance Corp., Bloomberg Markets magazine reports in its September issue.

Lohman, 52, left the money untouched for six months after her son's August 2008 death.

"It's like you're paying me off because my child was killed," she says. "It was a consolation prize that I didn't want."

As time went on, she says, she tried to use one of the "checks" to buy a bed, and the salesman rejected it. That happened again this year, she says, when she went to a Target store to purchase a camera on Armed Forces Day, May 15.

I'm Shocked'

Lohman, a public health nurse who helps special-needs children, says she had always believed that her son's life insurance funds were in a bank insured by the FDIC. That money -- like $28 billion in 1 million death-benefit accounts managed by insurers -- wasn't actually sitting in a bank.

It was being held in Prudential's general corporate account, earning investment income for the insurer. Prudential paid survivors like Lohman 1 percent interest in 2008 on their Alliance Accounts, while it earned a 4.8 percent return on its corporate funds, according to regulatory filings.

"I'm shocked," says Lohman, breaking into tears as she learns how the Alliance Account works. "It's a betrayal. It saddens me as an American that a company would stoop so low as to make a profit on the death of a soldier. Is there anything lower than that?"

Millions of bereaved Americans have unwittingly been placed in the same

position by their insurance companies. The practice of issuing what they call "checkbooks" to survivors, instead of paying them lump sums, extends well beyond the military.

Touching Americans

In the past decade, these so-called retained-asset accounts have become standard operating procedure in an industry that touches virtually every American: There are more than 300 million active life insurance policies in the U.S., and the industry holds $4.6 trillion in assets, according to the American Council of Life Insurers.

Insurance companies tell survivors that their money is put in a secure account. Neither Prudential nor MetLife Inc., the largest life insurer in the U.S., segregates death benefits into a separate fund.

Newark, New Jersey-based Prudential, the second-largest life insurer, holds payouts in its own general account, according to regulatory filings.

New York-based MetLife has told survivors in a standard letter: "To help you through what can be a very difficult, emotional and confusing time, we created a settlement option, the Total Control Account Money Market Option. It is guaranteed by MetLife."

No FDIC Insurance

The company's letter omits that the money is in MetLife's corporate investment account, isn't in a bank and has no FDIC insurance.

"All guarantees are subject to the financial strength and claims-paying ability of MetLife," it says.

Both MetLife, which handles insurance for nonmilitary federal employees, and Prudential paid 0.5 percent interest in July to survivors of government workers and soldiers. That's less than half of the rate available at some banks with accounts insured by the FDIC up to $250,000.

Bank of New York Mellon Corp. handles the paperwork and monthly statements for customers with MetLife "checking accounts." The insurance company, not the bank, most recently reported holding about $10 billion in death benefits, in 2008.

The "checkbook" system cheats the families of those who die, says Jeffrey Stempel, an insurance law professor at the William S. Boyd School of Law at the University of Nevada, Las Vegas, who wrote 'Stempel on Insurance Contracts' (Aspen Publishers, 2009).

'Bad Faith'

"It's institutionalized bad faith," he says. "In my view, this is a scheme to defraud by inducing the policyholder's beneficiary to let the life insurance company retain assets they're not entitled to. It's turning death claims into a profit center."

Prudential's Alliance Account is helpful to families of soldiers, says company spokesman Bob DeFillippo.

"For some families, the account is the difference between earning interest on a large amount of money and letting it sit idle," he says. Prudential follows the law, he says.

"We fully and regularly disclose the nature and terms of the account to account holders," DeFillippo says. "We make it clear that the money can be withdrawn at any time by simply writing a draft."

Metlife spokesman Joseph Madden says his company's customers are very happy with the Total Control Account.

'Overwhelmingly Positive'

"The feedback from TCA customers has been overwhelmingly positive," he says. "The TCA affords beneficiaries security, peace of mind and time to make an informed decision -- while earning interest in the interim."

Madden says the company was paying some survivors 0.5 percent in July while some others got 1.5 percent or 3 percent, depending on the age and origin of insurance accounts. The accounts don't violate any laws, Madden says, and are authorized by New York state insurance law.

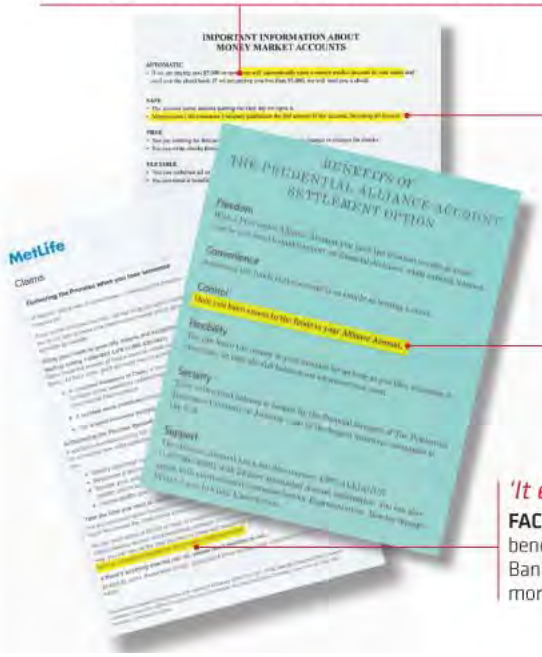
Insurers are holding onto at least $28 billion owed to survivors, according to three

Deceptive Language

In assurances to policyholders and letters to beneficiaries, insurance companies mislead people about 'checkbook' accounts.

'We will automatically open a money market account in your name'

FACT: There's no money market account set up for survivors. MetLife holds the death-benefit payouts for federal employees in its own general account.



'SAFE ... MetLife guarantees the full amount'

FACT: The money isn't covered by FDIC insurance. In its death-benefit claim form for federal employees, MetLife omits that funds aren't in a bank and aren't insured.

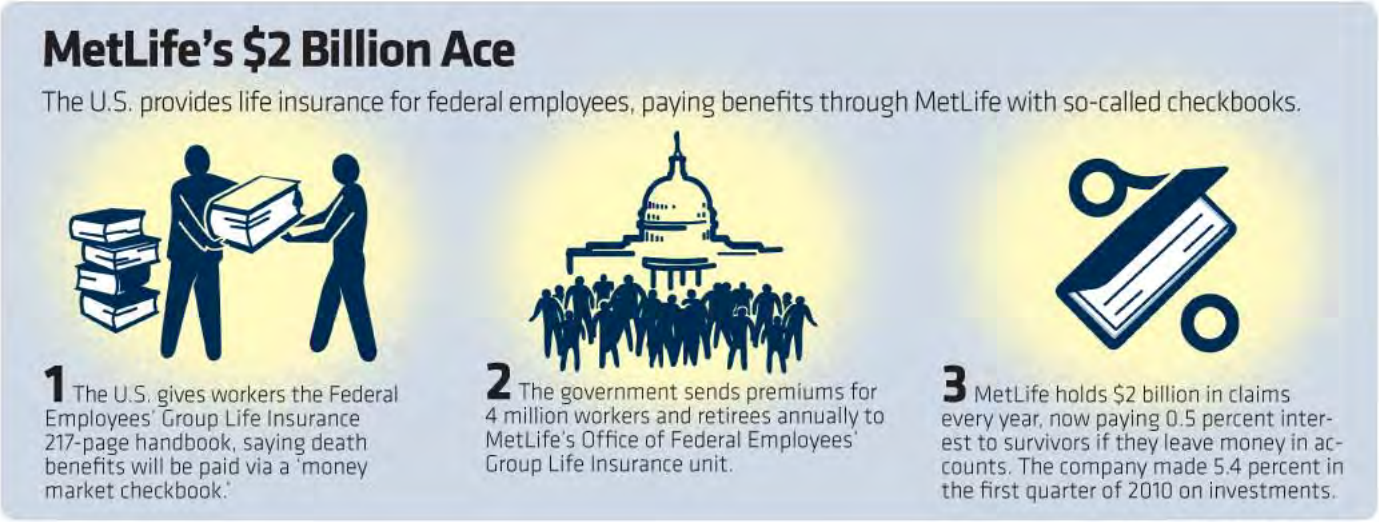
'Only you have access to the Alliance Account'

FACT: All of the death-benefit money is in Prudential's general account, and only Prudential has access to that.

'It earns a competitive interest rate'

FACT: MetLife and Prudential pay 0.5 percent to beneficiaries of federal employees and soldiers. Banks offer money market accounts paying more than twice that, with FDIC insurance.

Sources: MetLife, Prudential



Sources: Metlife, U.S. Government

firms that handle retained-asset accounts for about 130 life insurance companies. There are no public records showing how much companies are holding in these accounts.

The "checks" that Cindy Lohman wrote, the ones rejected by retailers, were actually drafts, or IOUs, issued by Prudential. Even though the "checks" had the name of JPMorgan Chase & Co. on them, Lohman's funds weren't in that bank; they were held by Prudential.

Federal Bank Law

Before a check could clear, Prudential would have to send money to JPMorgan, bank spokesman John Murray says.

Insurance companies -- in addition to holding onto the money of survivors, paying them uncompetitive interest rates and giving them misleading guarantees -- may be violating a federal bank law. A 1933 statute makes it a felony for any company to accept deposits without state or federal authorization.

That means only banks or credit unions can accept deposits, says Arthur Wilmarth, a professor at George Washington University Law School in Washington who has testified before Congress about banking regulations.

If a prosecutor pressed an insurance company, retained- asset accounts could be outlawed because insurers say they deposit money into these accounts and don't have bank charters or banking regulation, Wilmarth says. MetLife also offers its own version of certificates of deposit.

"If it swims, quacks and flies like a duck, the court could decide that it is indeed a duck," he says. "You then potentially could have a criminal violation."

Potential Bank Run

This unregulated quasi-banking system operated by insurers has none of the protections of the actual banking system. Lawrence Baxter, a professor at Duke University School of Law in Durham, North Carolina, says the potential exists for a catastrophe.

If one insurer is unable to meet its obligations on retained-asset accounts, people could lose faith in other companies and demand immediate payment, triggering a panic, says Baxter, who has consulted with federal agencies on financial regulation.

The government established the FDIC in 1933 after frantic depositors tried to pull their money from banks. The federal government has no such program for death-benefit accounts.

"There's more than $25 billion out there in these accounts," Baxter says. "A run could be triggered immediately by one insurance company not being able to honor its payout. The whole point of creating the FDIC was to put an end to bank runs."

No Federal Regulation

The sweeping financial regulatory legislation signed by President Barack Obama on July 21 doesn't address retained-asset accounts. It creates a new federal insurance office, which won't be a regulator. It will collect information, monitor the industry for systemic risk and consult with state insurance regulators.

An industry with $19.1 trillion in potential liabilities will remain unregulated by the federal government. In 2008, insurers approved claims totaling $60 billion in death benefits, according to the life insurance council.

The federal government doesn't even regulate the life insurance it supplies, via MetLife, to its own employees in a program called Federal Employees' Group Life Insurance. As the VA does for soldiers, the U.S. Office of Personnel Management sends handbooks to nonmilitary government workers -- some 4 million active employees and retirees.

The handbook says their life insurance policies automatically pay out death benefits in the form of a "money- market-account checkbook." The 217-page handbook omits that the money isn't FDIC insured and will stay with MetLife until someone writes a "check."

'Unfair Advantage'

This lack of disclosure is unconscionable, says Harvey Goldschmid, a commissioner of the U.S. Securities and Exchange Commission from 2002 to 2005.

"I can't imagine why bank regulators haven't been requiring a prominent 'no FDIC insurance' disclosure," says Goldschmid, who's now a law professor at Columbia University in New York. "This system works very badly for the bereaved. It takes unfair advantage of people at their time of weakness."

The closest relative to retained-asset accounts may be money-market mutual funds, which are pools of cash invested in short-term debt securities.

Money Market Rules

The SEC requires fund companies to warn investors that money market funds don't have FDIC insurance. It also mandates that fund managers provide a prospectus, that they invest in specific types of safe debt and that they post a detailed schedule of their investments monthly on their websites.

Insurers' retained-asset accounts have none of those regulatory protections.

A June 2009 MetLife standard condolence letter to survivors leaves out that accounts aren't in a bank and aren't federally insured. In June 2010, 25 years after MetLife invented retained- asset accounts, the company released a customer agreement that does disclose that retained assets aren't in a money market account nor in a bank and that they have no FDIC insurance.

"The assets backing the Total Control Accounts are maintained in MetLife's general account and are subject to MetLife's creditors," the agreement says. That language contradicts the federal employee handbook, which says survivors get a money market account.

Gerry Goldsholle, the man who invented retained-asset accounts, says MetLife makes $100 million to $300 million a year from investment returns on the death benefits it holds. A former president of MetLife Marketing Corp., Goldsholle, 69, devised the accounts in 1984. He's now a lawyer in private practice in Sausalito, California.

'This Is Crazy'

Goldsholle says he pondered the billions of dollars of death-benefit proceeds the company paid out each year.

"I looked at this and said this is crazy," says Goldsholle, who left the firm in 1991. "What are we doing to retain some of this money? It's very expensive to bring money in the front door of an insurance company. You're paying very large commissions and sales expenses."

So he came up with a way for MetLife to hold onto death benefits.

"The company would win because we would make a nice spread on the money," Goldsholle says, while customers would earn interest on their accounts. MetLife, he says, can earn 1 to 3 percentage points more from its investment income -- mostly from bonds -- than it pays out to survivors.

Misconceptions

The accounts Goldsholle invented have spread much faster than the ability of state regulators to track them -- or even to understand how they work. Ted Hamby, North Carolina's deputy insurance commissioner for life and health, says he believes retained-asset accounts have FDIC protection.

"Whatever money is on deposit in that checking account will be insured, up to the limits of the FDIC," he says. He's wrong. No retained-asset accounts have FDIC coverage.

In Connecticut, where 106 insurance companies are based, state insurance department manager for market conduct Kurt Swan also says that retained-asset accounts are kept in banks, with FDIC coverage.

"I think they're just trying to offer some flexibility to the beneficiary," he says. Swan and his colleague, William Arfanis, the department's principal financial examiner, both say the insurers don't profit from the retained-asset accounts. That too is wrong. The companies do earn investment gains on death benefits.

Some Rules

Just six states had any rules for retained-asset accounts as of July 2009, according to the National Association of Insurance Commissioners. Arkansas, Colorado, Kansas, Nevada, North Carolina and North Dakota require insurers to disclose fees and interest rates and to tell survivors they may withdraw all of the money by writing a single check.

Maryland, which isn't on the NAIC list, also has rules.

Pennsylvania Insurance Commissioner Joel Ario, whose state has no rules for retained-asset accounts, says he has asked his staff to prepare a regulation forbidding insurance companies from using such accounts as the default method of paying a death claim.

"I haven't heard a plausible argument about why these accounts are better for the consumer," Ario says.

If state insurance regulators have paid scant attention to retained-asset accounts, state bank regulators have taken an even more hands-off approach.

'Not Drawn Attention'

"Quite honestly, we deal with issues that our members want us to deal with," says Michael Stevens, senior vice president for regulatory policy at the Washington-based Conference of State Bank Supervisors. "This is not one that has drawn their attention."

Three companies have not only noticed but have also profited by handling retained-asset accounts for insurers. Open Solutions Inc., based in Glastonbury, Connecticut, oversees 400,000 accounts for 67 insurance companies.

Open Solutions sends out "checkbooks," prints periodic statements and computes accrued interest for accounts with total deposits of $10 billion, says Jay Woldar, director of sales and account management at Open Solutions.

One of its competitors, Bank of New York Mellon, administers more than 500,000 retained-asset accounts holding a total of $14 billion, including MetLife's retained assets. Chicago-based Northern Trust Corp. handles about $4 billion in 125,000 accounts, spokesman John O'Connell says.

Survivors generally don't touch these accounts immediately.

Accounts Stay Opened

"About 40 percent of the money stays in for more than a year," Woldar says. Insurers can have use of survivors' money for years, even decades, says Randi

Lichtenstein, a product line manager at Bank of New York.

"They can stick around for quite a while," she says. "There are accounts that all insurance companies have on these platforms that go back 10, 15, 20 years."

MetLife's Madden says most of its customers' retained-asset accounts are closed within one year. About 28 percent of survivors of soldiers and veterans keep their retained-asset accounts open for more than two years, the VA says.

During a routine audit completed in 2004, the New York State Insurance Department found that 1,476 retained-asset accounts, worth a total of $33.5 million, at Hartford, Connecticut-based Phoenix Life Insurance Co., had been dormant for more than three years.

In New York, funds in an account that remains dormant for more than three years may be turned over to the state. Phoenix spokeswoman Alice Ericson says the company now has a policy of sending letters to people whose accounts have been inactive for two years.

Inactive Accounts

Almost one-third of the 6,890 retained-asset accounts run by Mony Life Insurance Co. were inactive for more than three years, New York auditors found in 2002. Mony is now owned by Axa SA, Europe's second-largest insurer by market value.

A few people have sued insurers over the use of retained- asset accounts. Prudential won a lawsuit in 2009 in which a survivor complained about the Alliance Account. MetLife has a case pending in which a survivor says that she was cheated by the retained-asset account. In court-filed papers, MetLife denies any wrongdoing.

There has been only one ruling by a federal appellate court on the substance of such accounts -- and it went against an insurance company.

After a federal judge in Boston dismissed a policyholder suit claiming that Chattanooga, Tennessee-based insurer Unum Group was stealing account earnings from survivors, the U.S. Court of Appeals for the First Circuit overruled the lower court in 2008. It reinstated the case.

'Euphemistically Named'

"The euphemistically named 'Security Account,' accompanied with a checkbook, was no more than an IOU which did not transfer the funds to which the beneficiaries were entitled out of the plan assets," the three-judge panel wrote.

Unum spokeswoman Mary Clarke Guenther says retained-asset accounts are a commonly accepted practice in the industry. The case is pending.

Absent regulatory or legal intervention, bereaved family members like Cindy Lohman will continue to find death benefits going into retained-asset accounts. Her son, Ryan, posthumously received a Purple Heart and Bronze Star Medal for sacrificing his life to save fellow soldiers in Afghanistan in August 2008.

He had ordered a Humvee to swerve to avoid an explosive device, exposing himself to its deadly blast.

'Accept The Reality'

Three days after learning of her son's death, Lohman says, an Army casualty assistance officer came to her home, explaining that Ryan had a life insurance policy and that her signature was needed to release the money.

"By signing that, it forced me to accept the reality that he was dead and not coming back," she says.

Since 1999, the VA has allowed Prudential to send survivors "checkbooks" tied to its Alliance Account. In 2009 alone, the families of U.S. soldiers and veterans were supposed to be paid death benefits totaling $1 billion immediately, according to their insurance policies. They weren't.

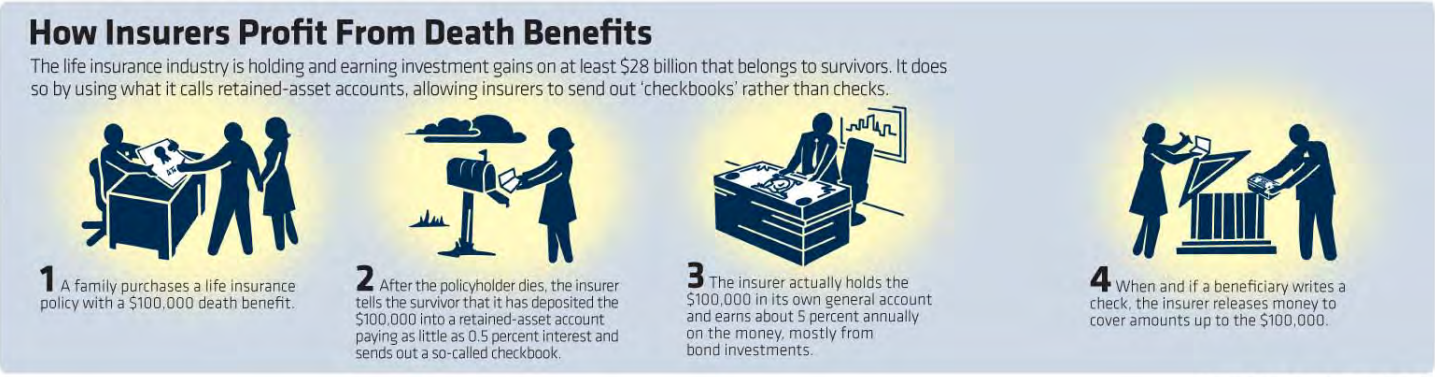
Prudential's VA policies promise either a lump sum payout or 36 monthly payments. About 90 percent of survivors, including Lohman, choose to receive the full amount upfront. When they do, they don't get a check; they get a "checkbook."

Under a 2008 law, survivors covered by Prudential's VA policy are allowed one year to put death benefits into a Roth IRA, allowing them to earn investment gains for the rest of their lives tax-free. Prudential never informed Lohman, she says.

'If They Had Told Me'

"I definitely would have done that if they had told me," Lohman says.

Even Stephen Wurtz, deputy assistant director for insurance at the VA, who has overseen the insurance program for 25 years, has been kept in the dark by Prudential.



Sources: MetLife, Open Solutions, Prudential

"Prudential runs the program on a cost-reimbursement basis only," he initially said, referring to the $4.2 million in fees the VA paid Prudential in 2009. "They're really good guys. They do it patriotically. They don't make any money from the Alliance Account."

Wurtz, 62, said he had believed that the Alliance Account money went into a bank. After he learned that the payouts actually stayed in Prudential's general fund, Wurtz says, he asked Prudential how much money the insurance company made from these accounts and how many dollars it held in retained assets.

Prudential declined to answer, saying that information was proprietary, Wurtz says.

'Maybe I Didn't'

Prudential, which has had the insurance contract with the VA since 1965, pitched the checkbook payout to the VA in 1999 as an added benefit to survivors, Wurtz says. The government agency accepted Prudential's offer, he says.

"Maybe I didn't ask enough questions," he says.

Printed on each "check," next to "Prudential's Alliance Account" is the name of JPMorgan, the second-biggest U.S. bank by assets. JPMorgan spokesman Murray declined to say how much the bank is paid for its role with Prudential.

The way Prudential has set up the "checks" implies that JPMorgan stands behind the accounts and that they are thus backed by the FDIC, Duke's Baxter says.

"That's misleading the beneficiaries," he says.

"We disclose the roles of all companies involved in administering these accounts," Prudential's DeFillippo says. JPMorgan's Murray declined to comment.

Prudential's general account earned 4.4 percent in 2009, mostly from bond investments, according to SEC filings. The company has paid survivors 0.5 percent in 2010.

'It's Shameful'

"It's shameful that an insurance company is stealing money from the families of our fallen servicemen," says Paul Sullivan, who served in the 1991 Gulf War as an Army cavalry scout and is now executive director of Veterans for Common Sense, a nonprofit advocacy group based in Washington. "I'm outraged."

Sullivan, a project manager at the VA's benefits unit from 2000 to 2006, says he was never told Prudential kept money and earned investment gains from soldiers' insurance payouts instead of sending it to survivors.

"There shouldn't be secret profits," he says. "This should be transparent. The lack of oversight is appalling."

It's not much different for the 4 million nonmilitary U.S. government employees and retirees -- including staff of the FDIC -- covered by MetLife policies. That program, begun in 1965, averages more than $2 billion in death benefits claimed every year, the government says.

Payouts are handled by the Office of Federal Employees' Group Life Insurance. That makes it look like the government is taking care of its employees' insurance coverage. It isn't. That "office" is a unit of MetLife.

MetLife Holds the Money

Edmund Byrnes, a spokesman for the Office of Personnel Management, which oversees MetLife's federal employee contract, says MetLife segregates death benefits into beneficiary accounts after it approves death claims.

"Once MetLife transfers the funds to the Total Control Account, the monies are no longer under MetLife's control," Byrnes says.

MetLife spokesman Madden says something different.

"The assets that back the liabilities on all the TCAs are placed in MetLife's general account," he says.

Back at the Veterans Affairs office, Deputy Assistant Director Wurtz, who's a civilian employee, says he now understands for the first time that since he's covered by the federal insurance program, his own wife could receive a MetLife "checkbook" someday.

'Ripping Off Their Own'

"Uncle Sam is ripping off their own," Wurtz says. "My wife would get the money, and they would blood-suck some of it out of her."

It took Wurtz, who's been working with insurers for most of his career, more than a decade to understand how retained-asset accounts work. Companies like MetLife and Prudential have never told millions of Americans with insurance policies that when they die, the insurer plans to hold their family's money in its own account to make investment gains from the death benefit.

"It's outrageous that somebody's profiting off other people's grief," says Mark Umbrell of Doylestown, Pennsylvania. His 26-year-old son, Colby, an Army Airborne Ranger who earned a Bronze Star and a Purple Heart, was killed in Iraq in May 2007. Umbrell was among those who got a "checkbook" account.

"I think we're being taken," he says.

The question for Umbrell, Lohman and a million others with these accounts is whether anything will change. State bank regulators say if there are to be any reforms, they should be made by insurance departments. Officials at those state agencies often say they don't even understand what a retained-asset account is.

"It's flown under the radar," professor Stempel says. "Regulators have not done their job."

Until public officials wake up, the bereaved will remain a secret profit center for the life insurance industry.

– Editors: Jonathan Neumann, Gail Roche

Veterans Agency Made Secret Deal With Prudential

By David Evans

Sept. 14 (Bloomberg) -- The U.S. Department of Veterans Affairs failed to inform 6 million soldiers and their families of an agreement enabling Prudential Financial Inc. to withhold lump-sum payments of life insurance benefits for survivors of fallen service members, according to records made public through a Freedom of Information request.

The amendment to Prudential's contract is the first document to show how VA officials sanctioned a payment practice that has spurred investigations by lawmakers and regulators. Since 1999, Prudential has used so-called retained-asset accounts, which allow the company to withhold lump-sum payments due to survivors and earn investment income on the money for itself.

The Sept. 1, 2009, amendment to Prudential's contract with the VA ratified another unpublicized deal that had been struck between the insurer and the government 10 years earlier -- one that was never put into writing, Bloomberg Markets magazine reports in its November issue. This verbal agreement in 1999 provoked concern among top insurance officials of the agency, the documents released in the FOIA request show.

For a decade, until the contract was formally changed, Prudential wasn't fulfilling its obligations to survivors of fallen service members, says Brendan Bridgeland, an insurance lawyer who runs the non-profit Center for Insurance Research in Cambridge, Massachusetts.

Robert Gates, U.S. secretary of defense, listens during a cabinet meeting with U.S. President Barack Obama at the White House in Washington, D.C.

'Violated Terms'

"It's very clear they violated the original terms of the contract," says Bridgeland, who is retained by the National Association of Insurance Commissioners to represent consumers.

"Every veteran I've spoken with is appalled at the brazen war profiteering by Prudential," says Paul Sullivan, who served in the 1991 Gulf War as an Army cavalry scout and is now executive director of Veterans for Common Sense, a nonprofit advocacy group based in Washington. "Now vets are upset at the VA's inability to stop Prudential's bad behavior."

That the VA allowed Prudential to issue retained-asset accounts for 10 years while the contract required lump-sum payouts is "more evidence that the VA was asleep at the wheel for a decade," says Sullivan, who was a project manager and analyst at the VA from 2000 to 2006.

"When grieving families check the box that they want a lump sum, they should get it. We remain disappointed and irate at the VA's failure to provide advocacy for veterans," he says.

State and U.S. Probes

Since July 28, when Bloomberg Markets first reported that Prudential sent checkbooks instead of checks to survivors requesting lump-sum payouts, state and federal officials have demanded the retained-asset system be investigated and reformed. The VA itself launched a probe of its life insurance program the day the first story was published.

The next day, New York Attorney General Andrew Cuomo launched what he called a "major fraud investigation" of Prudential and other life insurers over their use of retained- asset accounts. Since then, Cuomo's office has issued subpoenas to Prudential and at least 12 more insurance companies.

The insurance departments in Georgia and New York have also opened probes. The U.S. House Oversight and Reform Committee plans to hold hearings into Prudential's use of retained-asset accounts to pay money owed to fallen soldiers' survivors.

'News to Me'

U.S. Secretary of Defense Robert Gates -- who was in office when the 2009 agreement was signed -- said when the VA started its probe that he had been unaware that survivors were being sent retained-asset accounts.

"Until today I actually believed that the families of our fallen heroes got a check for the full amount of their benefits," Gates said at the time. "This came as news to me."

As a result of the VA probe, the agency announced today that it will change its insurance program, allowing survivors to request and receive lump-sum checks. Under Prudential's original 1965 contract with the VA and a 2007 revised contract -- both of which were released as part of the FOIA response -- the insurer is required to send lump-sum payouts to survivors requesting them. The contract covers 6 million active service members, their families and veterans.

The checkbooks Prudential sends to survivors are tied to what the insurer calls its Alliance Account. The checkbooks are made up of drafts, or IOUs, and aren't insured by the Federal Deposit Insurance Corp. Prudential invests the survivors' money in its general corporate account, where it can earn the insurer as much as eight times as much as it currently pays in interest to beneficiaries.

Bond Income

Prudential held $662 million of survivors' money in its corporate general account as of June 30, according to information provided by the VA. Prudential's general account earned 4.2 percent in 2009, mostly from bond investments, according to regulatory filings. The company has paid survivors holding Alliance Accounts 0.5 percent in 2010.

Families that were supposed to receive lump-sum payments under the terms of the contract before it was amended in 2009 may be able to successfully sue Prudential for lost interest, insurance lawyer Bridgeland says.

"Survivors would have a very strong claim for interest earned by Prudential on their money," he says.

Prudential spokesman Bob DeFillippo says his company is following the terms of its agreement with the VA.

"Prudential is in compliance with its contract with the Department of Veterans' Affairs," he says.

DeFillippo declined to comment on whether Prudential was in compliance with its contract between 1999 and September 2009 or to answer any other questions. Prudential chairman and Chief Executive Officer John Strangfeld declined to comment for this story.

Useful Service

In July, DeFillippo said Prudential's retained-asset account was a useful service for bereaved relatives of soldiers. "For some families, the account is the difference between earning interest on a large amount of money and letting it sit idle," he said. Survivors can withdraw some or all of their money at any time, he said.

Veterans Affairs Chief of Staff John Gingrich says the agency approved use of the Alliance Account because it wanted to help survivors.

"We needed to give an option to individuals that allowed them more flexibility and time to react to the tragic family situation," Gingrich says. Verbal Agreement

VA spokeswoman Katie Roberts declined to say when Veterans Affairs Secretary Eric Shinseki, who was appointed by President Barack Obama in January 2009, learned of the existence of the 1999 verbal agreement and the 2009 amendment. She also declined to make Shinseki available for comment.

The VA official who verbally agreed in 1999 to allow Prudential to change the terms of the 1965 contract and begin offering retained-asset accounts was Thomas Lastowka, the VA's director for insurance, according to Dennis Foley, a VA attorney. Prudential began sending Alliance Account kits to soldiers' beneficiaries in June 1999.

Foley says the VA and Prudential would have been better off if they had put their 1999 agreement in writing.

"Could that have been done better?" Foley asks. "Probably. Best practice would have been to legally memorialize it at the time."

Foley says the 1999 changes to the 1965 contract were valid, even if they weren't in writing, because they were made by mutual agreement by people empowered to make such decisions.

"It was changed by somebody who was authorized to change it," he says.

Contract Terms

The language of both the 1965 contract and the 2009 amendment make clear that Newark, New Jersey-based Prudential was required to adhere to the original terms until

RThe headquarters building of Prudential Financial Inc. stands in Newark, New Jersey, U.S. Photographer: Emile Wamsteker/Bloomberg

2009, regardless of any handshake agreements in 1999, insurance lawyer Bridgeland says.

The 1965 contract says any alterations must be made in writing.

"No change in the Group Policy shall be valid unless evidenced by an amendment thereto," it says. "No Agent is authorized to alter or amend the Group Policy."

The VA and Prudential signed a revised contract in 2007, saying it was "amended in its entirety." That contract, with the exact same words as the 1965 agreement, required that Prudential pay survivors with lump sums.

The 2007 revision included the same procedures in the 1965 agreement requiring any changes be made in writing. It contained no mention of the retained-asset system, or of the verbal agreement struck in 1999.

2009 Amendment

It wasn't until Sept. 24, 2009, that the changes agreed to by VA official Lastowka and Prudential in 1999 were put into writing. The 2009 amendment allowing Prudential to hold onto death benefit payouts was made retroactive to Sept. 1, 2009, not back to 1999.

By putting in writing a change that was verbally adopted 10 years earlier, the VA is effectively trying to backdate the amendment, says Jeffrey Stempel, an insurance law professor at the William S. Boyd School of Law at the University of Nevada, Las Vegas, who wrote 'Stempel on Insurance Contracts' (Aspen Publishers, 2009).

"They're trying to reinvent history," Stempel says. "You really can't do that. This is a blatant giveaway by the VA with nothing for the agency or the people in uniform."

Nine of every 10 survivors ask Prudential for lump-sum payments, the VA says. Prudential sends those families "checkbooks" instead of checks.

'Disasters Do Happen'

Documents released in the FOIA request show some signs of concern within the VA after Prudential proposed the retained- asset accounts in 1998. Lastowka, the official who allowed Prudential to introduce the Alliance Accounts, said that the insurer's "checkbook" system wasn't protected by the FDIC.

"Disasters do happen," wrote Lastowka, in an e-mail dated June 9, 1999, to Stephen Wurtz, the agency's deputy assistant director for insurance.

Lastowka said in his e-mail that the lack of FDIC coverage could backfire on survivors.

"Who is responsible if Alliance goes belly up?" Lastowka asked. "I think we have to also be prepared to defend the use of the Alliance Account."

Lastowka also asked whether Prudential had adequately disclosed to survivors that the Alliance Accounts weren't covered by FDIC insurance.

"Did Pru alert us to the non-FDIC fact?" he wrote to Wurtz. "Or was it in small print as the notice to beneficiaries?"

Documents turned over by the VA didn't include a response from Wurtz.

'Aware of Issues'

Lastowka says his e-mail shows the decision to allow Alliance Accounts was carefully considered.

"This e-mail demonstrates simply that the VA's Insurance program was aware of issues that might be raised as we implemented the payment method and that we should be prepared to respond to inquiries," Lastowka says. "We were confident that we were making a decision which would benefit survivors."

The FOIA documents show that on June 10, 1998, Prudential gave a presentation to the VA. It included 10 pages of key points, saying the Alliance Accounts would benefit survivors because they would provide safety, flexibility in how and when to use their money, competitive interest rates and customer service.

In fine print, at the bottom of one of the pages, was this caveat: "Funds in the Alliance Account are direct obligations of The Prudential Insurance Company of America and are not insured by the Federal Deposit Insurance Corporation."

Sheila Bair

Twelve years later, the issue of the lack of FDIC protection in retained-asset accounts flared anew.

FDIC Chairman Sheila Bair said in August that consumers could incorrectly conclude that retained-asset accounts were insured by the FDIC.

"The insurance company must take care to avoid implying in any way that these accounts are in fact FDIC-insured," she wrote in an Aug. 5 letter to state insurance regulators.

Some families of veterans have taken their complaints to court. Five survivors filed a federal fraud lawsuit in Boston on Aug. 30 against Prudential claiming the insurer has earned as much as $500 million in profits by improperly keeping beneficiaries' money instead of paying it out in a lump sum.

The suit, Lucey vs. Prudential Insurance Co. of America, says the insurer fraudulently claims to beneficiaries that the Alliance Account is a lump sum.

'This Ruse'

"Initiation of this ruse does not constitute payment of anything to anyone," the suit says. "The Alliance Account is merely a bookkeeping device used by Prudential to hold on to beneficiaries' money."

Prudential hasn't yet filed a response in court. Spokesman DeFillippo says he can't comment on the case.

"It is important to note that several federal judges have rejected claims against accounts like our Alliance Account, concluding that beneficiaries are in virtually the same position they would be in had the insurer sent them a check," DeFillippo says. He cited the dismissal of a case against MetLife Inc. on Sept. 10.

Insurance contract professor Stempel says that regardless of the outcome of that lawsuit, it's clear that Prudential and the VA wrongly manipulated a federal contract at the expense of military members and their relatives. "At a minimum, survivors ought to be made whole with their missed interest," he says. "The VA really seems to have had the best interests of the insurance company at heart, instead of those of the soldiers and their families.

-Editors: Jonathan Neumann, Dan Reichl, Patrick Chu

Prudential Profits From Slain Soldiers With Help From Taxpayers

By David Evans

Sept. 30 (Bloomberg) – When Prudential Financial Inc. invests the death benefits owed to survivors of soldiers killed in battle, the money comes from a source with deep pockets: the U.S. government.

After a U.S. soldier dies in combat – including the more than 4,000 service members who have been killed in Iraq and Afghanistan – the Department of Veterans Affairs sends Prudential the full amount of each family's life insurance coverage, usually $400,000.

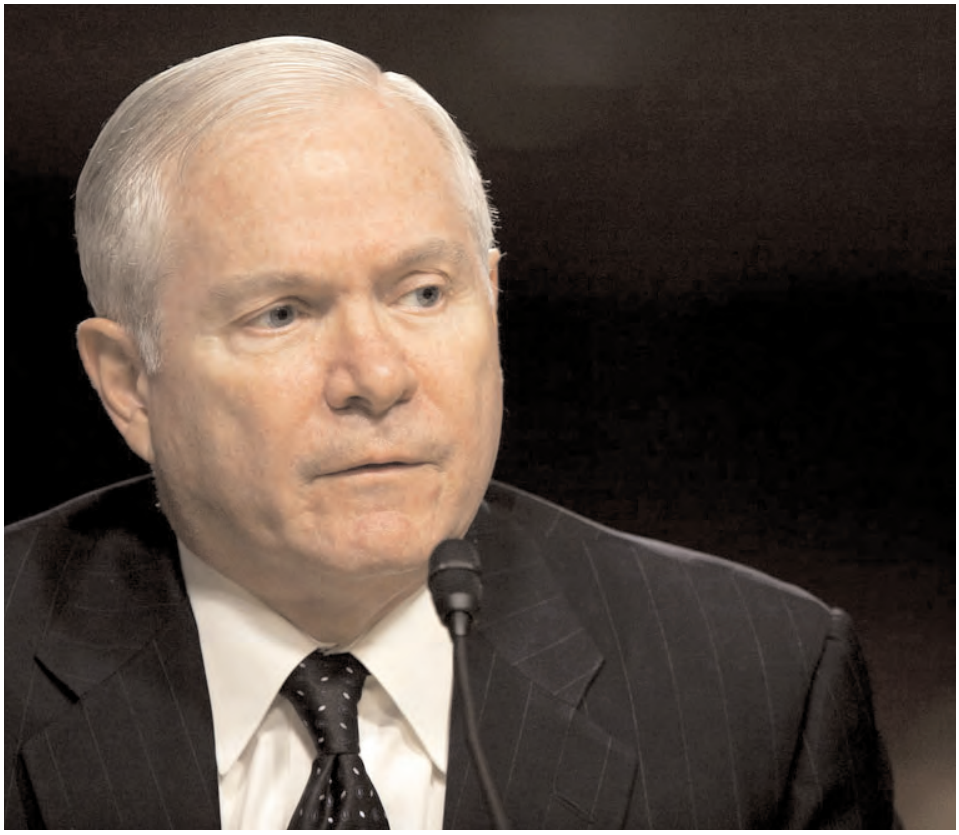
The government has paid Prudential $1.7 billion for these benefits since 2003, when the war in Iraq began, according to information provided by the VA, Bloomberg Markets magazine reports in its November issue.

Prudential holds that taxpayer money, invests it and reaps the gains.

Here's how it works: If survivors request a lump-sum payment of the death benefit, Prudential opens a so-called retained-asset account, a quasi-checking account that allows families to draw money when they're ready to spend it.

Until the money is used, it stays in Prudential's corporate account. There, the insurer invests the funds, mostly in bonds, making returns as much as eight times higher than what it is paying out to holders of the retained-asset account.

What this means is that Prudential is investing – and profiting from – death benefits owed to the families of slain soldiers, using money provided by the U.S. government.



US Secretary of Defense Robert M. Gates. Photographer: Joshua Roberts

'Sweetheart Deal'

"They have what appears to be a nice sweetheart deal with the federal government," says Michael Powers, professor of risk management and insurance at Temple University in Philadelphia. "This strikes me as the same sort of thing as those classic stories of the government paying hundreds of dollars for a wrench or a toilet seat."

Ninety-five percent of survivors paid by Prudential ask for lump-sum payments, the VA says. Since 1999, Prudential has sent out more than 60,000 Alliance Account checkbooks, instead of checks, covering more than $7 billion in death benefits when families asked for full payouts.

On average, Prudential holds about 16 percent of survivors' money for at least a year, according to Prudential. As of June 30, the company had $662 million belonging to military families in its general account, the VA says.

Prudential's general account earned 4.2 percent in the first half of 2010, regulatory filings show. The company paid survivors holding Alliance Accounts 0.5 percent in the same period.

'Ill-Conceived Giveaway'

"It sure looks like the VA provided an ill-conceived giveaway, or that Prudential played the VA like a fool," says Steven Schooner, co-director of the Government Procurement Law Program at George Washington University Law School in Washington. "It's a lose-lose proposition for everyone but Prudential."

Prudential spokesman Bob DeFillippo says the professor is wrong.

"Prudential assumes the vast majority of mortality risk for the participants," he says. "We also assume all of the investment risk." He declined to elaborate on what Prudential's insurance and investment risks are.

The VA says it is taking steps to better help survivors.

"The VA is working to ensure that all aspects of the Alliance Account and all choices to the beneficiary are made absolutely clear and that all facts concerning the administration of the

accounts continue to be fully transparent and disclosed," says Thomas Lastowka, the VA director for insurance.

Probes Launched

Since July 28, when Bloomberg News first reported that Prudential sent checkbooks instead of checks to survivors requesting lump-sum payouts, state and federal officials have demanded the retained-asset system be investigated and reformed. The VA itself launched a probe of its life insurance program the day the first story was published.

The next day, New York Attorney General Andrew Cuomo launched what he called a "major fraud investigation" of Prudential and other life insurers over their use of retained- asset accounts. Since then, Cuomo's office has issued subpoenas to Prudential and at least 12 more insurance companies.

The insurance departments in Georgia and New York have also opened probes. The U.S. House Oversight and Reform Committee plans to hold hearings into Prudential's use of retained-asset accounts to pay money owed to fallen soldiers' survivors.

New VA Policy

The VA announced on Sept. 14 that Prudential had agreed to halt its practice of automatically sending checkbooks to survivors who ask to be paid with a lump sum. Instead, the insurer will offer families the option of receiving the full amount by check.

Prudential also said it would no longer include any official agency seal on Alliance Account checks, forms and correspondence – to avoid the appearance that they have been endorsed by the federal government. Prudential will also make clear that its account isn't protected by the Federal Deposit Insurance Corp.

The reason why taxpayers pick up the tab for all life insurance benefits owed to the families of soldiers killed in combat goes back 45 years.

Before the Vietnam War, the U.S. government ran its own life insurance programs, with separate plans specifically created for World War I, World War II and the Korean War. By 1956, the military had closed to new enrollments all of the programs insuring combat soldiers.

Insuring Soldiers

To provide coverage for troops being sent into harm's way in Vietnam, Congress adopted a law in September 1965 – proposed by the life insurance industry – creating the Servicemen's Group Life Insurance program.

The plan was modeled after a group life insurance system for nonmilitary federal employees that Congress enacted in 1954. That one is administered by MetLife Inc.

The 1965 law required that, for the first time, the federal government would work with a life insurance company to cover war deaths. Congress also put into the law another mandate endorsed by the industry, which was concerned about the casualty rate among soldiers in Vietnam.

The Life Insurance Association of America endorsed a provision guaranteeing that the government pay the full costs to the insurance company for death benefit payments due to families of soldiers killed in battle. The private company would not be on the hook for payouts owed to any soldiers slain in combat.

No-Bid Contract

Nine days after President Lyndon Johnson signed the bill into law on Sept. 29, 1965, the VA awarded a no-bid contract to Prudential. The program is set up so that the government deducts premiums from soldiers' pay. The government holds the money for a short while and then sends it to Prudential.

The insurer uses that money to pay benefits for deceased military members who didn't die in combat. Prudential puts cash not immediately needed to pay claims into a reserve fund. The company invests that money and puts all the gains back into the reserve.

Today, the VA's contract with Prudential covers 6 million active service members, their families and veterans. Lastowka says his agency isn't considering putting the contract up for bid. Since 1965,

the VA has paid Prudential annually to cover administrative expenses, most recently $4 million in 2009.

Before Prudential started using the Alliance Account in 1999, the insurer's government contract wasn't a moneymaker, VA Chief of Staff John Gingrich says.

'Make Money'

"Where Prudential has the option to make money is the Alliance Account," Gingrich says. Alliance Accounts hold survivor money for families of both soldiers killed in war and those who died in other circumstances.

The first taxpayer money made its way into Alliance Accounts in 2003, as soldiers died in Iraq and Afghanistan, according to VA documents.

After taxpayers covered $18 million that year, annual payments to Prudential peaked at $460.9 million in 2007. Taxpayers sent Prudential $213.2 million in 2009. The seven-year total of public funds going to the company was $1.7 billion, 95 percent of which went into Alliance Accounts.

The VA doesn't reimburse Prudential for benefits owed to families of soldiers who died noncombat deaths, but it does help the insurer in another way. The agency provides a financial cushion.

To do that, it has set soldier premium payments at levels high enough to build up a so-called contingency fund, which Prudential manages. The VA says that fund held about $835 million as of June 30, 2009.

Too Large

The contingency fund is too large, Lastowka says. VA actuaries have determined

UThe headquarters building of Prudential Financial Inc. stands in Newark, New Jersey, U.S.

it should hold about $230 million less, he says. As a result, the VA lowered soldiers' premium payments by 7 percent to $26 a month starting on July 1, 2008.

Even with that change, the contingency fund provides Prudential more backup than VA actuaries recommend.

"It's a very low-risk situation," Lastowka says. In the 45-year history of the VA insurance program with Prudential, the money in the contingency fund has always been sufficient to cover all of the claims the company had to pay out.

In 1965, before Congress created the new insurance program, the American Legion tried to convince lawmakers not to contract with an insurance company.

The nation's largest veterans' service organization, chartered by Congress in 1919, expressed concern that the government would set and collect premiums, do record keeping and pay for war deaths – so there would be no need for an insurance company.

'Widows and Orphans'

"Nothing remains, really, for the commercial companies to do except realize a profit," American Legion executive John Corcoran said at a hearing on Sept. 9, 1965. "Indemnifying the lives of our servicemen and providing a degree of protection to their parents, widows and orphans is not a business transaction; it is the responsibility of the government."

Peter Gaytan, executive director of the American Legion in Washington, says the organization's position hasn't changed: "We have to overhaul the system so nobody can make profits off soldiers who died in action."

-Editors: Jonathan Neumann, Dan Reichl, Patrick Chu