LEARNING RESOURCES
FOR PRIVATE DISABILITY

Book 1
SETTLEMENTS

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INTRODUCTION

Thank you for purchasing Book 1 of DCS' Learning Resources for Disability – "Settlements"

The objectives of this learning experience are as follows:

- At the end of this reading insureds and claimants will better understand the importance of discount rate, mortality value, present and future values, and life choices important to financial planning.

- Insureds will be able to identify Compromise Settlements from Non-Compromise Settlements and differences in amounts offered.

- Insureds will be more informed as to the life and financial consequences of a lump-sum settlement for any disability claim.

I apologize in advance for the complexity of information that at first glance may appear confusing and numerically complicated. However, if you follow the examples given in the book carefully I'm sure you will have a better understanding of what settlements are all about.

The information described below is very important in understanding a disability insurance settlement. Therefore, I begin with a foundation of basic concepts so that you will be well informed before we get to how the settlement process actually comes together.

I am confident that you will find the information shared with you to be meaningful and important to your own personal decision-making. It may seem a bit numerically confusing at first, but please try to hang in there - it will be worth it!

If you have any questions please feel free to contact me at DCS@metrocast.net . I have referral attorneys who are extremely successful in negotiating settlements, or, if you need additional information please feel free to let me know.

TO "SETTLE" OR NOT TO "SETTLE"

Individuals who have been receiving private disability benefits for more than 12-24 months may want to consider whether a settlement is a good option for themselves and their families. Exhausted from the constant demands of the disability insurer for more and more medical, financial and occupational information, many people begin to look for other options to obtain a "buy out" and rid their lives of the insurance company once and for all. Or, perhaps the insurance company has contacted you with a settlement offer and you need to understand whether or not you are being made a reasonable offer close to the present value of your policy.

By definition, an Individual Disability Income Replacement (IDI) settlement is "an offer and acceptance of a sum of money for the giving up of all rights owned by the insured under a policy contract to any future benefits possible, and the release of the policyholder from the liability of payment for all future claims." In reality, when both parties sign an insurance "all future claims" settlement, the insured is surrendering the policy to the policyholder, and as of the date of execution of the settlement, the policy is no longer in force or enforceable.

It should be noted, however, that those considering ERISA settlements have already waived their rights under the employer's group Plan as "certificate holders", not owners of the Plan, and there is no ownership in a policy they can surrender. ERISA claimant's who accept buy-outs are removed from participation in the employer's group Plan. This is why it is very important for claimants to check with their employers prior to signing a settlement release to determine how other group benefits will be affected when LTD stops as a result of a buy-out.

Disability insurance settlements are, for the most part, life choices. Consideration should be given to all of the possible impacts a lump-sum settlement could have on future income as well as the quality of life you want to have in the future. Consultants and attorneys alike should always counsel insureds concerning the important facts relating to disability claim settlements such as these below.

- ✓ Recognizing that the equivalent of one month's benefit will be removed from your investment account each month, is the gross lump-sum offer sufficient to meet your future financial needs?
- ✓ Am I ill advisedly trying to obtain cash from a long-term source of income to resolve short-term debt?
- ✓ Will I be able to manage my lump-sum amount in a responsible way so that my future income needs will be met?
- ✓ Are current investment portfolio interest rates sufficient to provide me with income to equal future value at age 65? If not, what is the amount of future value lost if I accept a settlement?
- ✓ Will a lump-sum settlement unnerve me, or cause me additional stress when regular monthly income is not forthcoming? Will I be scared if there is "no check in the mail?"
- ✓ What are my additional or alternative sources of income for the future, specifically after the age of 65 when my policy would have ended anyway? Is there shared income from a spouse?
- ✓ Is a lump sum settlement taxable? What additional loss of future value will I have due to taxes?
- ✓ What kind of future value losses am I willing to accept in order to get "out from under" a harassing insurance company? Am I more inclined today to accept a settlement offer because I feel harassed and exhausted by risk management? Will I feel differently later?
- ✓ What types of safe investment opportunities are available to me for investment purposes? What is the going market rate of interest for different types of investment such as annuities, money markets, and T-bills?

The above is by no means an all-inclusive list of “life” considerations that should be thought out before accepting any disability claim settlement. The point is, that all claim settlements affect future financial stability in some way. Each individual family has a unique set of circumstances and no two-settlement situations are the same.

Accepting a disability claim settlement could potentially be a very wise decision, or not a good one at all. Settlements are “life decisions” and the impact on family futures should always be considered prior to signing on the dotted line.

In addition, insurance companies do not “settle” claims unless there is a profit reason for doing so. Therefore, in most circumstances, private disability settlement must be considered with a fair degree of skepticism.

It is a myth believed by many that “a fair settlement” represents 100% of the future value of a claim. For example, the first instinct of any insured is to calculate what a good offer would be by multiplying the monthly benefit times the number of months to age 65 or lifetime. **If you are only willing to give up the policy for 100% of its future value, then a disability insurance settlement is NOT for you.**

DEFINITION: **Future value represents the value of any disability claim by multiplying the number of months remaining to maximum duration of claim by the monthly net benefit amount.**

For example, Sarah is now 41 years old and has a disability policy maximum duration to age 65. Her monthly benefit is $1,600/month.

The future value of Sarah’s policy is: 65 minus 41 leaves 24 years, or 288 months left to age 65. $1,600 per month x 288 months equals a future value of $460,800. This is the amount Sarah will receive if she refuses to accept the lump-sum settlement and continues to receive benefits to age 65. However, the $460,800 **is NOT the value of her policy today**, a very important concept in settlement negotiations. I’ll be discussing this a bit later.

The only way to receive 100% of the value of a disability policy is to receive an annuity of equal payments in equal periods of time (benefit months) to the maximum duration of the policy. Since all insurance involves “risk” and future benefits are always uncertain, those who consider settlements must be willing to “give up” some future policy value in order to settle claims.

The value of what is given up in order to accept an insurance settlement is a real, and in some cases, a significant loss to insureds. Therefore, it is impossible for an insured to receive a settlement offer from a disability insurer for 100% of the future value of the policy to age 65 or lifetime attained age. Understanding that it is necessary to “forfeit some future value” of the policy in order to settle is essential to the process of successful settlement resolutions.

Again, if you are unwilling to accept less than 100% of the future value of the benefits, then a disability settlement is not for you and you should continue to receive the monthly benefit and accept the risk of the uncertainty of having future benefits denied. Disability claim settlements are not for everyone, or every life situation.

CONDITIONS FOR SETTLEMENT

There are certain conditions that must be met before any disability insurer will consider a disability policy settlement or lump sum buyout to an insured. Insurance settlements outside of litigation are not in the control of insureds. Settlement is therefore an option exercised by the insurer to rid the company of claims and/or certain "blocks of business."

Insureds have no demand authority when it comes to disability settlements; meaning insurers cannot be compelled to offer settlements just because insureds ask for them. Settlement is generally not an area of claims management over which insureds have any control. Claim settlement offers are strictly under the control and option of the insurance company.

Insureds should also keep in mind that most disability insurers, with the exception of Unum Group and The Hartford, are not "settlement companies" as a matter of usual and customary claims internal claims procedures. If Mass Mutual is asked to consider settlement the usual response is, "we pay claims that should be paid and deny those that should be denied". We don't offer settlements as a general rule." Disability Management Solutions, Inc. "DMS" may offer settlements since reinsurers look to hand off claims as soon as possible.

The Hartford intensely investigates settlement requests often to the point of demanding IMEs, making it risky on the part of insureds to ask for a settlement. Other insurers do not as a general rule offer settlements as part of their normal claims process. Therefore, disability claim settlements, again with Unum Group as the exception, are few and far between even though the same insureds' skills and principles should be applied.

For those companies who offer claim settlements, it is usually only under the following conditions: (Remember this refers to settlements outside of litigation.)

- ✓ The insurer performs all "risk management" activity with no resulting conclusive evidence the claim could credibly be denied. Risk management activities include: surveillance, field visits, medical reviews etc. Most insurance companies have guidelines as to how much money can be spent on "risk management" in proportion to the financial reserve of the claim, but when it becomes evident the insurance company will have liability to pay the claim to maximum duration cited in the policy, a settlement may be considered.

- ✓ The disability insurer wants to get rid of old "unprofitable" blocks of business such as Unum's Equitable and New York Life lines. Keeping unprofitable lines of business on the books may affect investment ratings for insurers and therefore the companies often offer settlements to eliminate old lines of business. Remember, it is possible for any insurance company to have various relationships with other insurers such as acting as third-party administrator, reinsurer, or wholly owning subsidiaries. Removing unprofitable lines and/or relationships from a company Balance Sheet leaves "settlement" as a primary objective.

- ✓ For ERISA policies, there must be evidence the insured was awarded Social Security Disability Income benefits, both Primary and Family SSDI. Insurers will make absolutely sure they have information about all other sources of income that could reduce settlement offers.

- ✓ ERISA claims should be beyond the 24-month change in definition; and a Transferable Skills Analysis must be in the claim file documenting NO alternative gainful occupations have been located. If the insurer concludes the claim can be denied after the "any occupation investigation", it will not offer settlement.

- ✓ Claims are often settled on appeal in order to resolve claim conflicts without expensive litigation.

- ✓ There must exist an opportunity of showing a financial profit on the settlement. Disability insurers do not offer settlements unless a financial reserve profit can be generated. Unum, for example will not offer lump-sum settlement amounts greater than 80% of the claim financial reserve. As discussed later, this often becomes a guessing game for negotiation.

Insurers will also set guideline situations when settlements MAY NOT be offered to insureds. These include:

- ✓ Mental and nervous claims limited to 24 months of benefits and/or mental claims with patient therapy records of mention of suicidal ideation, or suicide attempts. Some insurers are willing to settle M&N claims but only after obtaining statements from a psychiatrist or therapist certifying competence. Mortality values are often higher when behavioral issues are present in the claim file.

- ✓ Insured mentions possible return to work in the future. If it looks like any insured will have work capacity in the future, most insurers will not offer settlement.

- ✓ Physician does not indicate in the patient notes that the insured is at MMI (Maximum Medical Improvement) and lists prognosis as Fair to Good within a 12 month period. Insureds but have patient evidence they are totally and permanently disabled.

- ✓ Red flags are evident in the claim file, suspicion of fraud exists, or management expects to be able to deny the claim in the near future.

- ✓ Insureds with high mortality values. (I'll explain this later.)

- ✓ Low financial reserve claims. Not worth the administrative cost of processing a settlement.

- ✓ Short-term disability claims.

However, here are several situations in which insurers might be inclined to offer settlements:

- ✓ SSDI award overpayments can be resolved via lump-sum claim settlement given all other above conditions have been met.

- ✓ High value reserve IDI claims that have been determined to be permanently disabled and payable to Lifetime benefits. On those occasions when insurers determine it is likely they will have liability for claims to maximum duration, settlement is considered and often offered.

- ✓ Blocks of claims that require constant administrative attention and have also been under reserved. It is better to offer settlements to under reserved claims than it is to contribute additionally to reserve amounts.

Disability insurers are not compelled to offer insureds the opportunity of settlement and the above conditions must be met before a settlement can be considered. Some disability insurers such as Aetna, CIGNA, and others do not offer settlements outside of litigation as a general rule.

Bottom line, if the insurer has any kind of evidence a claim can be credibly denied in the future, no settlement is generally offered.

TYPES OF SETTLEMENTS/RELEASES

Most insureds (and their attorneys) are unaware that there are two basic types of settlements:

ALL FUTURE CLAIMS SETTLEMENT - This is the ideal settlement for both the insured and insurer because a "full and final settlement" is agreed upon and both parties release the other from all duties, liability and future claims.

In effect, the policy is surrendered. What most insureds do not realize is that this should be the most "expensive" type of settlement in that the insurer is released from all future liability and the insured is willing to give up all interests in the policy. The insurer should pay a lump sum slightly more in order to obtain a full and final release of claim. Rarely do attorneys attempt to negotiate higher financial values for this type of release, but in my opinion, they should.

Today, the "All Future Claims Settlement" is the most common type of settlement since the primary objective for both parties is to rid themselves of any future liability or privilege to submit future claims. I am frequently asked by insureds whether the insurance company has any authority to "do something to them" after a settlement is executed, and my response is "No". Once a settlement agreement is signed, no further relationship exists between the two parties.

THIS CLAIM ONLY SETTLEMENT – This type of settlement involves a pay-out for only the current claim. For example, if a physician has a Paul Revere policy and wants to settle only on the current claim, then the signed release will state the agreement with the insurer is only for the current claimed liability and NOT for all future claims.

Once the settlement has been accepted and signed, the insured will continue to pay premiums on the policy and the policy will remain effective for any future claims. Normally, the insured is willing to settle for less money since the insurer has NOT been released from all future claims and the policy remains in force for future claims.

In my experience I've found that Unum Group is not likely to opt for "This Claim Only Settlement", but Northwestern Mutual and Principal will pay-off on the current claim and keep the policy in force as long as premiums are paid. It is a much more complex claim situation, however, Unum Group much prefers to rid themselves of the claim *and* policy at the same time. More sophisticated insurers will consider a "This Claim Only Settlement" if the claim situation reasonably warrants this type of resolution.

In addition, disability claim settlements can be generally described as either a "Compromise or Non-Compromise Settlement" See below.

COMPROMISE SETTLEMENT – A compromise settlement assumes that both the insured and the insurer admit to some duty or responsibility under the contract. The insured may agree that he/she could have some work capacity in another occupation, and the insurer agrees they will potentially have liability to pay the claim in the future. A compromise settlement can be either a "all future claims" or a "this claim only" settlement, but because of the mutual admission of liability, the amount of the settlement accepted should be less than just a straight "all future claims" settlement.

In a way, ALL disability claims settlements are compromise settlements because both insurer and insured "give up" some value in order to have a win-win situation for both parties. The major difference here is that a compromise settlement admits liability (insurer) and some work capacity (insured) and the amount offered should be less. Negotiating attorneys shouldn't expect to receive a higher percentage of present value for a Compromise Settlement.

NON-COMPROMISE SETTLEMENT – A non-compromise settlement is one in which the insurer admits it has liability for the claim to maximum duration. In combination with an "all future claims release" this is the type of settlement for which the most pay-out should be expected and received.

It is extremely important for insureds that are negotiating their own settlements as well as attorneys to recognize the expected differences in lump-sum offers depending on the type of claim situations being resolved. Is this an All Future Claims, Non-Compromise Settlement? If so, more pay-off should be expected. Conversely, if the claim is a Compromise, This Claim Only Settlement, a legitimate lower pay-out will be offered.

Although I've described the details of the types of settlements, realistically I don't think many insureds, attorneys, or insurance companies actually know the difference and perhaps won't negotiate accordingly. Nevertheless, those who are considering settlement should be aware that there is appropriate "theory" behind the process.

PRESENT AND FUTURE VALUE

Those of us who are middle aged can remember when a plain Hershey bar cost 25 cents. In 1973, I bought a brand-new Pinto wagon for $3,335 (not accounting for taste) and a Popsicle from the Good Humor man was only 5 cents. Obviously, the cost of goods 30 to 40 years ago was a great deal less than today. It took fewer dollars to buy more goods and services. What happened?

When the value of the American dollar declines, it takes more dollars to buy the same goods and services. This is referred to as the "purchasing power" of the dollar and its potential to buy goods and services.

To further illustrate the point, goods purchased for $1 in 1949 would require $9.03 in 2008 dollars in order to purchase the same amount of goods. Or, since 1949 the American dollar lost approximately 90% of its purchasing power, or if I were purchasing that same brand-new Ford Pinto in 2008 I'd have to pay $30,115, or a little over 9 times as much.

Another example closer to our topic is an insured with a policy worth $50,000 in 2006 who would need $53,399 in 2009 to buy the same amount of goods (pay bills etc.).

DEFINITIONS: **Future value is the purchasing power of $1 at some specified period in the future.**

Present value is the purchasing power of $1 today.

The difference between Future and Present value is interest, called "the Discount Rate".

An annuity is money that is received in equal payments for equal periods of time. All disability monthly benefits can be said to be a type of annuity.

The Discount Rate is defined as the rate of interest added to PV, or subtracted from FV.

The major concept of present value (PV) is that an insured can invest $1 today at *i* interest rate to earn or yield the future value (FV) for *n* number of periods. Stated simply, the difference between future value and present value is interest.

An insured looking to receive a lump sum settlement should be able to invest the lump sum for a period equal to the maximum duration of benefits, and receive the full future value of the policy. The PV of a claim plus interest equals FV; FV of a claim minus interest is PV.

Of course, one has to account for the fact that each month the value of one month's benefit will reduce the lump sum since you will have to remove an amount equal to your disability benefit in order to live.

PV also involves "compound interest." PV plus compounded interest equals FV. FV discounted (removal of compound interest) equals PV. PV is always <u>compounded</u> to arrive at FV; FV is always <u>discounted</u> to arrive at PV.

I'm sure you must be asking, "What has this got to do with my lump sum settlement?" Keep reading and I'll put it all together for you a bit later.

<u>MORTALITY VALUE</u>

Mortality value is somewhat of a misnomer for disability insurance since it is generally used in actuarial computations for life insurance.

<u>DEFINITION:</u> **Mortality value is the percentage greater than 100% that an individual is more likely to die than anyone else of the same sex, and age.**

Since all human beings die, we all begin with a 100% mortality value. Therefore, disability settlement amounts are reduced for each additional 100%. Unum Group, for example, might reduce its settlement offers in $10,000 increments for every 100% over 1,000 mortality value.

For example, Steven was diagnosed with terminal cancer. Using actuarial tables his insurance company calculated that his mortality value is 600%, meaning Steven is six times as likely to die as anyone else because he has cancer. If Steven requests a lump-sum settlement of his disability claim, his insurance company might reduce the settlement offer by some arbitrary amount.

Other examples include, a person with a severe cardiac condition who may well have a mortality value of 1,000%. This means the insured is 10 times as likely to die early (because of his condition) than a normal individual of the same sex and age. Likewise, for an insured with lung cancer now in remission requesting a settlement his/her mortality value might be 500% meaning the insured is 5 times more likely to die as all others his same age and sex.

When a settlement offer is calculated, it is customary for the insurer to add a mortality value cost (a reduction) from settlement offer representing the risk that an insured will die or return to work prior to the maximum duration of the policy. The use of mortality values in disability settlements can go from reasonable to ridiculous in a hurry.

Disability insurers, like many other things they do, frequently misuse mortality values in their favor especially in the area of settlements. While it might be reasonable to expect a heart transplant insured to have a mortality value of 1,000%, it is NOT reasonable for an individual with back pain to be given a mortality value of 500%. But, Unum, for example, will always tack on a mortality value claiming it represents the risk of death, or the insured's ability to return to work before the maximum duration of the claim, or the possibility of suicide for a mental and nervous claim.

For every 100% increase in the mortality value assigned, the disability insurer might reduce the calculated settlement amount by a specified dollar amount, say $2,000. Therefore, if the offer being calculated for the back-pain insured was $100,000 and the insurer claimed a mortality value of 500% the settlement calculation would be reduced by $10,000 (500% or 5 times over the normal mortality value x $2,000). You can easily see where a disability insurer might be able to use mortality values to represent situations other than death, such as expected return to work, going to jail in the future etc. Most mortality values are reasonable, but generally not an item that is negotiable.

There is always an exaggerated mortality value for mental health claims since the insurer will claim there is a possibility of suicide. Disability insurers do not like to settle mental or nervous claims to begin with therefore a mortality value is always present in the offer.

In general, mortality values are not negotiable since they are obtained from actuarial tables and insurers can allege the figures are objective and in keeping with available insurance data.

FINANCIAL RESERVES

Financial Reserves are amounts of money a disability insurer must set aside for the payment of future claims. This is actual cash that is unavailable for any other purpose. Claims presented for payment trigger an increase in the financial reserve that is reported on the insurance company's Balance Sheet as a liability.

Reductions in financial reserve are called Financial Reserve Gains and increases are referred to as Financial Reserve losses. Financial Reserve Gains are immediate contributions to profit while losses increase corporate liabilities.

Money set aside to pay future claims is invested to generate portfolio income for Unum that in turn reduces its liability for claims. Some insurance companies have several reserve values depending on whether they exclude interest from the reserve amounts. It would be interesting to do some research and find out exactly where Unum invests its premium and financial reserve monies.

Since claims are presented for payment AND denied every day, financial reserves fluctuate and are not consistent from day to day. However, with respect to settlements, while your claim is being paid, there is a financial reserve loss recognized. Should you agree to settle the claim the reserve is removed and a reserve gain is recognized as an immediate contribution to profit.

If the amount of the settlement is exactly equal to the claim reserve no profit or loss is recognized – it's a wash. However, companies such as Unum Group, and I assume The Hartford, will not settle claims for more than 80% of the financial reserve. Therefore, it makes sense to assume that every claim settled and closed produces at least a 20% profit by reducing the Financial Reserve. No insurance company actually loses when claims are bought out and settled.

In the past, insurance company settlement offers (particularly Unum) used Financial Reserves as the basis for determining the actual amount of cash offers. At that time actual Financial Reserve figures used consisted of a combination of actuarial and insurance historical data and were not reflective of "future values" of claims. It is alleged that using insurance accumulated historical data significantly under reserved the future values of claims.

Interestingly, employers were not happy with employee settlement offers using artificially created financial reserves since premiums paid by them were based on the underwriting of the potential future value of all claims of a particular group.

Therefore, Unum Group, for example, began using the future value of claims, but of course, created a threshold (80%) whereby the company continued to recognize gains for all settled claims. Although there was a time when Unum Group reported to regulators and the public that the company did not maintain claim financial reserves, the company continued to "reserve" amounts identifiable by claim.

With respect to current settlement offers and negotiations, most insurers will refuse to tell you what the claim financial reserve is. This often makes "negotiations" a real guessing game to determine how close the insurer's offer is to the 80% threshold.

While Unum Group never seems to admit to the financial reserve you can be assured that it is always the starting point for any lump-sum settlement offer. You should also be aware that insurers "under reserve" the future costs of claims, as I'll show you in the examples below.

THE DISCOUNT RATE

Companies such as Unum Group generally use what is referred to as Moody's Composite Corporate Bond Rate to discount Future Value to Present Value. Remember an interest rate used to <u>remove</u> compound interest is called "discounting". Calculating <u>added</u> interest from Present Value to Future Value is called "compounding."

Future Value – Interest = Present Value (Discounting)
Present Value + Interest = Future Value (Compounding)

Since settlement calculations remove interest from Future Value, the interest rate is called a "discount rate."

Moody's is a worldwide investment service described by its own Internet market material as "an essential component of global capital markets." The company establishes corporate credit ratings using the AAA evaluation method and manages financial markets by establishing average, or composite interest rates for corporate bonds offered for sale to the public.

Corporate Bonds are no more than IOU's, or debt instruments offered to the general public for investment purposes. When corporations want to raise money there are basically two ways to do it: 1) sell stock, and 2) offer Bonds for sale.

Investors buy corporate Bonds with the expectation of receiving semi-annual interest payments (often called the coupon rate) for the term of the Bond, say 5, 10 or 30 years. At the end of the term, the corporation returns the amount of the principle, and the gain to the bondholder is the interest received over the term of the Bond.

Corporate Bonds are traded on the open market and are regarded as low risk investments when compared to stocks and mutual funds. Investors can purchase Bonds at a Discount, for example, a $100 Bond for $75. At the end of the term of the Bond, the corporation pays $100 back to the bondholder thereby increasing the overall return on the investment equal to the semi-annual interest plus the additional $25.

Unum and other insurers use Moody's Composite Corporate Bond rates to discount Future Value to Present Value for disability claim settlements. The problem is, however, that Moody's Bond Rates are much higher than the going rate of interest for other investments since the rates are used from only Aaa rated companies. See below based on August 2017 rates:

Treasury Bills	1%
Money Markets	.75%
12-month IRA	1.40%
Fixed Annuities	8% for the 1st year, 2% for years 2-5, with a blended rate of 3.17%
Passbook Savings	.06%-1.00%
Moody's Bond Rate	4.5%

Technically, insureds are supposed to be able to invest disability claim lump-sum settlements at the discount rate to yield future value at maximum duration of claim.

Frankly, in our current economy, there are no risk adverse investments available to individual insureds that would guarantee future value of their claims. Insureds who must depend on the removal of one month's benefit to survive financially cannot invest in Corporate Bonds even short-term.

Although Corporate Bonds can be offered at a Fixed Rate of interest or "Indexed", meaning variable and fluctuating to the market, investment of settlement cash to receive minimal semi-annual interest payments for the term of the bond is unrealistic to most insureds, particularly those who have to live off the money by removing 1 months benefit to age 65 or lifetime.

Unfortunately, the use of Moody's Composite Bond rates results in a significant loss of future value since the real possibility of investing lump-sum settlements to yield 4%+ in our current economy does not actually exist.

Insureds considering settlements should have a basic understanding of how settlements are computed and what is financially involved, including the importance of the "discount rate." The higher the discount rate used to calculate Present Value the lower the offer will be. It's that simple.

There is an alternative thought, believed by a few attorneys, that the Discount Rate represents Unum's cost of borrowing money to pay the settlement. I don't buy that theory since technically Unum should already "reserved" the future value to pay the claim.

In my opinion, insurers choose the highest Discount Rate they can get away with to lower the PV that ultimately results in lower settlements. I also believe that Unum's under reserving claims puts the company in a predicament when trying to limit settlement offers to 80% of financial reserve to make a 20% profit on each settled claim.

In summary, there are no safe investment portfolio opportunities available to insureds to yield 100% of future value at maximum duration of claim. Whether or not insureds are willing to accept a loss of future value depends on each individual's life circumstances and other sources of income that will meet future living and retirement needs.

<u>IS THIS REALLY A SETTLEMENT OFFER?</u>

If the insurance company decides to make an offer to settle your claim, a letter is sent out containing the offer and an explanation of how the settlement amount was computed. There are two types of numerical settlement offers: 1) an offer supported by documented numerical justification (Unum Group) and 2) no justification as to the offer amount (The Hartford).

Please find below a sample settlement letter sent to an insured from Paul Revere Life and Accident Company managed by Unum Group.

"Dear Ms. Franklin,

We recently completed a routine review of your long Term Disability claim. At this time, we want to let you know about an alternative payment option that may be available to you.

What this Means to You

The Paul Revere Life Insurance Company <u>may offer</u> you $176,000 as a one-time, lump sum payment, which would be full and final settlement of your Long Term Disability claim.

Before a settlement offer can be extended a brief update regarding your medical and financial information is needed. The enclosed questionnaire will constitute medical and financial information necessary for your review. This form only needs to be completed if you would like to accept our settlement offer.

This letter will provide you with the details of what <u>may be offered</u> as full and final settlement of your claim. This <u>potential offer</u> is valid through April 16, 2016.

There is no obligation at all for you to accept this one time lump sum payment. If you are not interested in this settlement option, we will continue to pay your benefits each month as long as you continue to be eligible for benefits under your policy

How the Amount was Determined

When determining the amount of $176,000 we consider factors such as the following:

- *Medical and financial information available to The Paul Revere Life Insurance Company at the time of the review.*
- *The present value of anticipated future monthly benefits totaling $249,002.*
- *Moody's Composite Corporate Bond Rate.*
- *General uncertainties of the future, such as interest rate fluctuations, unforeseen accidents.*
- *Morbidity and mortality risks.*
- *The possibility of medical advancements.*

In planning for the future, <u>our company makes an investment of the money it anticipates it will need to pay your benefits. This money is invested with an interest rate that is competitive at the time of investment.</u> An offer extended to you is calculated using an interest rate of 4.45%. This is Moody's Composite Corporate Bond Rate as of April 2016.

The amount of money invested now to pay out anticipated future benefits, plus interest over next 87 months has an estimated value of $249,002. This is referred to as the "present" value of your anticipated future benefits.

The amount of $176,000 is 71% of the present value. This is because there are general uncertainties of the future, such as:

- *Interest rate fluctuations.*
- *Unforeseen accidents.*
- *Morbidity and mortality risks.*
- *The possibility of medical advancements.*

Next Steps

Please contact me to provide an update of your medical and financial information. A formal extension of any settlement offer will be based on this update.

We recommend that you review this offer with an attorney, tax consultant and/or financial advisor. The Paul Revere Life Insurance Company is not responsible for any tax consequences of any lump sum payment.

We also recommend you contact the employer through which you become covered under this policy, to determine if accepting a final lump sum payment of your Long Term Disability benefits will impact any other benefits you may be receiving or be eligible to receive, such as pension or health care benefits.

<u>Once an offer is extended</u> and you decide to accept our settlement offer, please:

Complete the enclosed Settlement and Release form.
Have your physician complete the enclosed Settlement Competency Statement, and
Mail these completed and signed forms in the enclosed envelope…"

A few essential notes about the letter:

- This letter may seem as though it is offering a lump-sum settlement, but it is not. It's what I call a "hook letter" because although it mentions a specific lump-sum amount, the use of the words and phrases, "may offer", or, "may be offered" suggests that Unum is really only interested in whether or not the insured would entertain the idea of settlement.

- In addition, the letter opens up the door to additional medical and financial claim review. In 2017 Unum Group has gone so far as to order Independent Medical Evaluations as part of its "update" to consider settlement. This is consistent with information that was provided to me that Unum is now using its Settlement Department as a means to investigate claims and not merely for settlement offers.

- Although Unum informs insureds there is no obligation to accept a settlement offer, if refused, claims are returned to the risk management pile where they will continue to be investigated over and over again.

- It's unclear to me why Unum writes, "*<u>our company makes an investment of the money it anticipates it will need to pay your benefits. This money is invested with an interest rate that is competitive at the time of investment.</u>* Unum is, of course, referring to its own Financial Reserve, but doesn't call it by name; it just informs you that there is amount set aside to pay claims that accrues interest. It could be argued by Unum that the letter discloses the existence of a Financial Reserve, but clearly no insured reading the letter would understand that.

Insureds should always read settlement “hook” letters very carefully to determine exactly WHAT is offered. Although the above letter appears to be a settlement offer it really isn’t, and Unum has the option of withdrawing after reviewing additional medical, financial and vocational information. It would be a mistake to automatically “jump into”, and agree to accept this offer without preparing for the subsequent intensive investigation of the claim.

Technically, Unum’s letter is convoluted. Wouldn’t it be a better game plan for Unum to investigate the claim first, and then send the “hook” letter? In my opinion, Unum sends potential settlement offers in order to save exhaustive time and money investigating claims for insureds who will refuse settlement from the onset.

PUTTING IT ALL TOGETHER

As an alternative to Mr. Smith’s monthly disability benefit, Unum Group offered him $86,096 in a lump-sum final payout with an “All Future Claims Release”. This represents 75% of the present value of his anticipated future benefits. (If the insurance company doesn’t disclose what the FV is, the number can be calculated as ($86,096/75%) = $114,794.66.)

Let’s have a closer look at an actual example.

Unum Group informed Mr. Smith the calculated PV of the future annuity of benefits is $114,794 meaning he should be able to invest the lump sum today at the discount rate used to determine present value and earn 100% of the future value of the policy to age 65.

No PV calculation was attached to the offer letter supporting the accuracy of the calculation. (Insureds should always request copies of the actual PV calculations.)

The interest rate used (more accurately referred to as the discount rate) is 4.5%. In looking up the Treasury bill (T-bill rate for corporate bonds) for September 2017 I found out the range of Treasury bill interest was 4.24-4.5 percent. **The higher the discount rate, the lower the present value will be.**

In this example, Unum calculated a mortality value of 275%. This insured had a long history of cardiac issues that included surgery. The mortality value cited by Unum appears to be reasonable for an insured with potentially dangerous cardiac issues. Cash reductions from the settlement offered should be minimal as a result of this mortality value.

The actual settlement offer of $86,096 is only 75% of the stated present value of $114,794.66. Therefore, the insured would have to invest $86,096 to earn 4.5% to age 65 in order to get the full FV of his policy.

Where in the world would an insured be able to invest his money to earn that kind of interest? And, this doesn’t take into account the necessity to remove an amount equal to one month’s benefit each month. The only way an insured would be able to recover the worth of the policy is to invest in high-yield stocks and futures (risky investments).

You may be asking why Unum only offered 75% of NPV (net present value). That’s a very good question.

In reality, the BIG question is where the $86,096 falls as a percentage of Unum's FINANCIAL RESERVE of Mr. Smith's claim. Most insurance companies will not tell you outside of litigation what the financial reserve figure is. If Unum refuses to settle claims for more than 80% of financial reserve, it places the insured or an attorney in a position of guessing what to counter offer.

Generally, if you ask the insurance company to disclose what the claim financial reserve is, it will respond in one of two ways: 1) there is no financial claim reserve, or 2) the information is considered confidential and proprietary. Either way, the insurance company won't reveal the financial reserve since you may be able to calculate the insurance company's profit and attempt to minimize it during the negotiations.

In my opinion, Unum, and perhaps The Hartford, only offer a percentage of NPV to keep lump-sum amounts offered under a certain percentage of the financial reserve. As I indicated previously, insurers insist on making a profit on settlement claims.

Consider this additional example:

- Mr. Smith was 62 at the time of the settlement offer.
- Maximum duration of his policy is to age 65.
- Pre-disability salary earnings were $123,497.
- His monthly disability benefit from Unum was $6,175 (60% of earnings). He was awarded Social Security Disability benefits of $1,961.

Calculate:

Monthly benefit $6,175

Less: SSDI/mo. $1,961

Net Benefit $4,214
$4214 x 36 months = $ $151,704

$151,704 is a reasonable estimate for the financial reserve since it is also the FV of the claim.

The maximum payout Unum will make is up to 80% of financial reserve or $121,363.

What was the anticipated future value figure cited by Unum - $114,794? Not so. The real future value of Mr. Smith's claim is $151,704.

But, using the figures Unum cited we could estimate the financial reserve Unum really has on record:

$114,794/80% = $143,492.50 or $143,493 rounded.

Therefore, it looks as though Unum **under reserved** its future claim value by $8,211. ($151,704 – $143,493).

$143,493 x 80% is $114,794. This is the maximum amount Unum will pay to settle this claim. Unum actually told Mr. Smith this was the future value.

$86,096/151,704 = 57%

The actual offer was only 57% of the financial reserve value, or 60% of what Unum alleges is the future value.

Unum informed Mr. Smith the future value of his benefits was $114,794. This was not truthful. The future value of his benefits is (or should be) $151,704. Eighty percent of this number is $121,363. Now we have information with which to negotiate since Unum will not accept a counter offer greater than $121,363.

In realistic cash value of the actual offer of $86,096 represented only 57% of the accurate financial reserve value. If the settlement is accepted by the insured, Unum realizes $35,267 (23%) profit on the claim. The insured believes he made out on the deal, but shouldn't he have received the additional 3% and not Unum? Unum could have offered him $121,363, (80% of the future value), or 75% of PV, ($91,022) if the real future value had also been the reserved amount.

The problem here is the possibility that Unum under reserved the claim to begin with. Since the claim is under reserved, Unum cannot offer a fair or accurate value at settlement and still make a profit. While under reserving the claim may seem to be profitable to Unum over the history of the claim, when it comes to settlements insureds do not get a fair deal.

Although I realize that some might have difficulty following the above example, it is important to understand how insurers cut themselves a deal. Attorneys who are negotiating disability settlements should also be aware of "Compromise vs. Non-Compromise", and other factors affecting settlement negotiations and outcome. Disability settlements are manipulated to benefit insurers, not insureds and claimants.

TAX CONSEQUENCES, ATTORNEY FEES AND EMPLOYER BENEFITS

So far in the settlement process insureds have already lost:

- ✓ 20% of the future value of the claim due to the insurance company's unwillingness not to settle for more than 80% of the financial reserve.
- ✓ A percentage of PV that is not offered and lost.
- ✓ Losses in market value due to investment failure opportunities to invest lump-sums at discount rate.

Insureds who make the decision to accept lump-sum buy-outs need also consider tax consequences. Settlements are taxable to the extent employers paid the premium. In other words, insureds that paid 100% of premium on the policy with after tax dollars, receive tax-free settlement money.

Unfortunately, those who settle ERISA Plans receive wholly taxable settlement dollars because employers paid 100% of the premium. Sometimes premiums are paid both by the employer AND the employee such as - employer 60% and employee 40%. In this case, the settlement lump sum is 40% tax-free and 60% taxable.

Depending on the amount of settlement, taxes can either be insignificant, or a real cost to insureds. Estimating taxes is not as simple as taking, for example, 15% from a tax table and applying to the amount of the lump sum.

Remember, your total amount of taxes due will also include other gross income for the taxable year including SSDI. If you haven't planned on taking a settlement in the taxable year (such as making quarterly estimated tax deposits), the tax cost to insureds could be a burden that significantly reduces settlement amounts, and as a result, future income.

In addition, attorney's fees can also be significant. Attorneys charge from 10-40 percent of the cash settlement to negotiate with insurers. Other attorneys will take a percentage of the increased income they were able to obtain for the insured over and above the settlement offer – a more reasonable fee.

Regardless, insureds still must claim the gross amount of the settlement on their tax returns and that includes the attorney fees even when the fee was a pay out not a source of income. In some cases, Unum (but not Hartford) will agree to divide the lump sum settlement into payments received in different tax years. This has the effect of reducing the insured's tax burden spread out over several years.

In the past, Unum hired an investment firm to set up fixed annuities so that insureds could receive monthly payments over time with better tax consequences. Insureds who are interested in accepting settlement but prefer a monthly fixed annuity option should mention that to Unum before signing the release.

It might be possible for insureds and claimants to continue to receive monthly annuity payments directly from a settlement fund set up by Unum's financial third-party resource. Annuities have far better tax treatment than lump-sum settlements paid all in one taxable year.

If Unum is no longer willing to offer "investment" options, it is wise to consult an financial investment counselor who will help you set up one or several annuities so that monthly benefits received can equal the disability payment and there is no loss in income as a result of settlement.

ANNUITIES 101 FOR FINANCIAL PLANNING

Although it would be impossible for me to give you all of the details relative to annuities, a brief introduction would be extremely helpful to those trying to decide whether the annuity option is right for them.

Annuities have always been very unique means of investment. They provide investors with ways to accumulate funds for the future and then by a system of payments (or return of investment), distributes funds over a given period of time.

By definition, annuities are financial contracts issued by insurance companies who then invest premium dollars to earn interest. Funds accumulate in an annuity on a tax-deferred basis that adds to the overall growth of the investment. Funds are permitted to compound at a greater rate because none of the earnings are taxed away.

At a certain point in the annuity contract's history, the insurer – at the owner's discretion- will convert all or a portion of the contract's funds into a series of periodic income payments. Payments are calculated to extend for a certain number of years, or for the owner's lifetime. This process is referred to as "annuitization" meaning applying capital to purchase income.

Of special interest to those considering disability buy-outs is the "Immediate Annuity". Within a very short period of time after the annuity is purchased, usually within one month, the funds the owner deposited are annuitized and converted into a guaranteed stream of periodic income payments while the principal continues to earn a fixed rate of interest.

These payments are configured to last as long as the owner wishes; for a set number of years for the annuitant's lifetime, or for the joint lifetimes of two annuitants, such as the owner and his or her spouse. An immediate annuity requires the payment of a single lump-sum premium upon contract purchase.

Again, before accepting a disability claim settlement, it recommended insureds seek out the consultative services of a financial investment broker who can further advise on the benefits of the annuity option for investment of settlement lump sums.

LOSS OF EMPLOYER BENEFITS

In some cases, accepting a lump-sum payout for a disability claim/policy means that employers will no longer pay for group health and other benefits. Many employers today are integrating health care, life insurance and pension contributions with continuation of LTD. Once a claim is settled with a buy-out insureds may find themselves without employer coverage of health insurance and other benefits.

The problem of health insurance could be resolved if insureds have been approved for SSDI, or are 65 years or older and are eligible for Medicare. Still, some consideration should be given to whether employer extended benefits would cease if a settlement were accepted.

COBRA is not considered a cost-effective means of paying for health insurance and clearly Obama Care from the marketplace is costly if income guidelines preclude subsidizing premiums. Therefore, it is always a good idea for insureds to contact their Employers before accepting a claim settlement.

PERSONAL CONSIDERATIONS BEFORE SIGNING

Earlier in this eBook I said that settling a disability claim for a lump sum was a life choice, and indeed it is. Here are several personal situations that should at least be considered before signing a disability settlement.

- Think about whether you will be disciplined enough to actually invest the lump sum, or will you be tempted to spend the money quickly leaving you without resources in the future. Truthfully, having the capability to manage large sums of money is not for everyone.

- Do you have an important need for the money right now that may be tempting you to negotiate a settlement; for example, college tuition, divorce or foreclosure? If you do spend the money for a specific purpose how will you financially support yourself in the future? Long-term investments should never be used to settle short-term debt such as paying off credit cards.

- Is there a potential “offset” or reduction of benefit that will happen in the future such as settlement of a workers’ compensation issue, approval of social security or mandatory retirement benefit which may make it beneficial for you to negotiate a settlement now versus later? Settlements can often be used to resolve large SSDI overpayments.

- What if you are able to return to work at some time in the future and your monthly benefit stops? If you settle your claim now, the full lump sum is yours even if you return to work.

- Are you concerned about having money to leave a spouse, child, or relative in case anything happens to you? Beneficiaries can be designated on an Annuity contract providing income to children and spouses. Disability contracts pay Survivor Benefits equal to three months gross benefits only.

- How much do you hate having to deal with the disability insurer? What are the risks the insurance company will deny your claim and leave you without financial support in the future? Are you willing to take a lesser amount in settlement just to be rid of the control of the insurance company? Are you so angry or scared that you may be jumping the gun (so to speak) by asking for a settlement? Are you making a decision to settle out of fear?

- What are the tax consequences of the settlement? Will the lump sum be fully taxable? Instead of receiving the lump sum in one payment, do you need to have it distributed to you over several tax years?

- Are there riders to your policies that increase the value? Riders such as COLA, future increase options. SSRI riders etc. should be added to the settlement value at their present value as well as the benefit amount. In other words, the PV value of COLA and other riders should be calculated separately and then added to the PV of the policy.

- Are you the type of person who will become extremely nervous and anxious when you realize there is no more “check in the mail?” Does getting a check every month give you some type of security you won’t be able to live without?

- Have you contacted your employer to find out how an LTD settlement will affect payment of future benefits? If your employer integrates continued benefits with LTD, benefits will terminate as of the date of signing of a full release settlement.

SETTLEMENT Q & A

If I ask my disability insurer for a settlement offer will they consider the request a red flag?

They might if you are insistent about it. In today’s terms Unum uses it’s Financial Services Unit as another trail to risk management if it looks as though something is out of place on the claim, referred to as “a red flag.”

However, all of the disability insurers consider such requests an opportunity for resolution of your claim, within their own guidelines and limitations of course. Insureds can simply, write to the insurance company and say something like, *“I am now willing to consider any reasonable offer of settlement as a final resolution to my claim.”*

Keep in mind the insurance company is under no obligation to make an offer of settlement. You can request your claim be forwarded to the Financial Services Unit for consideration of settlement, but that doesn't mean the referral will actually take place. The claims handler will let you know if the company is willing to offer a settlement, but it may take several weeks to work through the red tape.

What happens to my claim if I am approached about a settlement and turn it down?

If you decide to decline Unum (or The Hartford's) settlement offer, your claim is returned directly to the "risk management" pot. While neither insurance company punishes insureds for turning down settlement offers, insureds need to be aware that claims will continue to receive risk management attention as they did before the offer.

My advice is to leave the door open to future offers by responding, *"While a settlement is not suitable for my financial situation today, I would like to receive additional offers in the future."*

Remember, claims will re-enter the risk management process when settlements are turned down even to the point of being denied in the future. The insurance company is not penalizing you for refusing to settle, but your claim will re-enter the risk management process.

If I think the settlement amount is too little can I counter-offer?

Yes. However, because of the 80% cap of financial reserve rule, there may be very little wiggle room depending on where the offer compares with the financial reserve. If the insurer is acting as though they don't want to increase the offer, it's probably because of the reserve cap.

Some insureds tend to think Unum and other insurance companies HAVE to negotiate, but just the opposite is true. Unum, for example, has been known to shut down the settlement offer immediately when it's obvious insureds are rejecting the initial sum.

Of the variables used in calculating settlements – PV, FV, Discount Rate, Mortality Value and Percentage of NPV (Net Present Value), the only one negotiable is percentage of NPV offered. No other variable is negotiable.

Also, don't expect Unum to significantly increase its settlement offer. Most attorneys are able to wrangle several months of additional benefits in addition to the settlement, but Unum is NOT compelled to increase its settlement offer just because insureds think negotiation is warranted.

Claim settlements are also NOT litigation settlements where the possibility of punitive damages may suddenly increase an otherwise low offer. Insurers can simply tell you to "forget it."

Do I have to retain an attorney?

No, you don't have to hire an attorney, but I'm strongly suggesting that you do, particularly if the settlement amount is over $50,000. We all want to keep insurers honest and within the boundaries of fair and equitable settlement deals.

I also recommend insureds have an initial consultation with an investment advisor soon after a settlement offer is made. Explore all of the low-risk investment options available to you before you decide to sign the settlement release. This way, you can be assured of future income that will meet your needs.

Can I ask for more time to decide whether I want the settlement or not?

Of course you can. But, expect the PV of the lump sum offer to decrease every 30 days. The more time you take to make a decision the less the offer will be as the insurer continues to pay monthly benefits in the interim.

SUMMARY

Understanding disability settlements can be complex as well as worrisome as you wonder, "Am I getting a good deal?" In fact, many insureds and claimants are so fearful of low-ball offers they refuse settlement without doing the necessary fact-finding that making a good decision requires.

One of the most popular questions put to DCS is whether or not the insurer can do anything to insureds after a settlement is signed. The only relationship insureds/claimants have with insurers is that which is written and described in the Plan or policy contract. When the Plan/contract is terminated, as in a settlement, the relationship goes away and neither party has any obligation toward the other.

Insurers who contact insureds out of the blue with settlement offers have an agenda. Generally, settlement "hook" letters are sent out 30 days prior to the end of a profitability-reporting period such as quarter-end or year-end. Profit is the primary motivation for offering settlements.

Secondarily, insurers offer unexpected settlements to rid their Balance Sheet liabilities of unprofitable blocks of business, such as when insurers are acting as reinsurers, or perhaps because they've purchased an extremely unprofitable subsidiary.

Insurers are not trying to help you in any way, and clearly all settlement offers maintain that margin of financial reserve profitability at the expense of insureds. Remember, if the claim is under reserved, settlement offers are much lower than they should be.

Insurers, such as Unum Group, will ensure its 20% contribution to profitability by offering much lower settlements. It's interesting to me that most people, including attorneys who negotiate settlements, have no idea why some offers are lower than others, but I can attest to the fact it's usually because claims are under reserved.

Insurers can't offer 80% of FV when the true FV isn't used as the financial reserve. I've often wondered how the SEC and state regulators would regard the fact that some insurers are so grossly under reserved.

The truth is, there are many insureds and claimants who accept disability claim offers of settlement and are glad they did. Having done their homework in researching facts and numbers they go on with their lives, often sharing with me later, " I'm really glad I don't have to look over my shoulder anymore." And it's true, they don't.

Therefore, if the numbers are good and you've done your homework to understand the process, then a claim settlement is the right decision for you. Your life is your own and no further relationship exists between you and the insurance company.

The real key to understanding settlements is information and knowledge about a process that is extremely important to you and your family. I am open to feedback concerning this first EBook and I appreciate your valuable time in advance.

Good luck to you with whatever decision you and your attorneys decide to make. If you have any unanswered questions after reading "Settlements" please feel free to send me an email or give me a call.

"Settlements" was written by Linda E. Nee, a nationally known expert in the field of disability claims. While working for Unum Life and UnumProvident, Linda was trained as a senior settlement specialist.

Today, Linda is the sole owner of Disability Claims Solutions, Inc., a private disability claims consulting company that provides fee-based consulting to those with private disability claims.

The issue of settlements remains one of the top sources of questions posed to DCS, Inc.

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