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FROM THE ARCHIVES: April 19, 2002

Companies Profit on Workers' Deaths Through 'Dead Peasants' Insurance

By ELLEN E. SCHULTZ and THEO FRANCIS
Staff Reporters of THE WALL STREET JOURNAL

Felipe M. Tillman loved music -- opera, jazz, country. He played keyboards and drums, sang and was choral director at his Tulsa, Okla., church. To make ends meet, he worked at record stores, where "he could be close to the music," says his brother Anthony Tillman. One of those jobs was a brief stint in the early 1990s at a Camelot Music store.

In 1992, Felipe, then 29 years old, died of complications from AIDS. He never bought life insurance, so his family received no death benefit. But CM Holdings Inc., then the parent company of Camelot Music, did. It received $339,302.

Like hundreds of other large companies, CM Holdings took out life-insurance policies on thousands of its employees, with itself as the beneficiary. Most workers covered this way don't know it, nor do their families.

Felipe Tillman

"If someone is going to use your name for something, even though you're an employee of theirs, you should know what's going on in your name," says Anthony Tillman, who was surprised to learn that his brother's death benefited Felipe's onetime employer. "It isn't fair."

The practice is as widespread as it is little-known. Millions of current and former workers at hundreds of large companies are thus worth a great deal to their employers dead, as well as alive, yielding billions of dollars in tax breaks over the years, as well as a steady stream of tax-free death benefits. Nestle USA has policies covering 18,000 workers, Pitney Bowes Inc. has policies covering 23,000, and Procter & Gamble Co. has 15,000 covered workers, spokespeople for these companies confirm.

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The coverage is called broad-based insurance, or corporate-owned life insurance, usually shortened to COLI. For years, companies could insure only key personnel deemed essential to the business. But a loosening of state rules in the 1980s allowed for an explosion in a new kind of COLI that covers rank-and-file workers -- known in the insurance industry as janitors insurance or, in at least one instance, dead peasants insurance. "I want a summary sheet that has ... the

Dead Peasants in the third column," one of Winn-Dixie Stores Inc.'s insurance consultants wrote in a 1996 memo. Winn-Dixie wouldn't comment on the memo.

Companies have put millions of dollars into COLI policies. These policies yield tax-free income as their investment value rises, just like conventional whole life policies. Companies also borrow against the policies to raise cash. Public Service Co. of New Mexico has noted in public filings in recent years that it once set up life-insurance coverage on hundreds of its managers to raise money to enable it to eventually take its nuclear-power plants out of service.

Until 1996, the biggest lure was the tax deductions companies were taking on interest they paid on these loans. But then the Internal Revenue Service began disallowing these deductions, arguing in subsequent disputes that these COLI arrangements serve no legitimate business purpose. Now, the agency is investigating more than 85 companies that it says took $6 billion in illegal deductions, an IRS spokeswoman confirms.

Even without those deductions, a company's bottom line still benefits from the tax-free investment gains on the policies and the death benefits. Companies can use the death benefits for anything they like. CM Holdings used $168,875 of the death benefit on Mr. Tillman for executive compensation, court documents show. The documents also show that $280 went to "Star County Children's Services" to help cover child-support payments from a nephew of Camelot Music's founder who was working at the company at the time.

'JANITOR INSURANCE'

Companies that have life-insurance policies on employees profit when the employees die*

- American Electric Power
- AT&T
- Ball
- Basset Furniture
- Dow Chemical
- Eaton
- Nestle USA
- Olin
- Pitney Bowes
- PPG Industries
- Procter & Gamble
- Trans World Entertainment**
- Walt Disney

*Some policies also cover ex-employees and retirees
**Acquired Camelot Music/CM Holdings

Most companies say they use money from the insurance to help pay for various employee benefits. A Pitney Bowes spokeswoman says the company instituted the program in 1994 "to offset the rising cost of employee benefits." A spokesman for Nestle says, "We have not done this for financial gain." A spokeswoman for Procter & Gamble says the company uses the insurance "partially to finance retiree health benefits."

Tom Ayres, spokesman for American Electric Power Inc., a Columbus, Ohio, gas-and-electric utility that has COLI policies covering more than 20,000 workers, says the policies improve the company's bottom line. Investment gains on the policies add to income, he says, and "as the insured employees die, we're getting death benefits, which is cash income." But he adds that the death benefits are "dedicated to retiree benefits," though the individuals covered by the insurance receive nothing directly.

John Sullivan, chief financial officer of Trans World Entertainment Corp., an Albany, N.Y., company that acquired CM Holdings in 1999, said he couldn't comment in detail because of a case pending in the U.S. Court of Appeals in Philadelphia. In that case -- similar to others brought by Winn-Dixie, AEP and Dow Chemical Co. -- Trans World is seeking to have reinstated some interest-payment tax deductions it took on borrowings against its janitors insurance. A federal district court had earlier granted an IRS request to disallow the deductions during CM Holdings' bankruptcy proceedings.

Mr. Sullivan does say that Trans World "inherited the policies" from CM Holdings. Those policies covered at least 1,400 employees in 1990, based on a company document reviewed by The Wall Street Journal. The document, called a death run, lists on page after page the names, ages and Social Security numbers of the workers, as well as how much money the company will receive for each employee's death, even those who die long after leaving the company. Younger workers

will generate from about $400,000 to almost $500,000 in death benefits each, the document shows, while older workers will bring the company about $120,000 to $200,000 each. (Younger workers yield bigger payouts because, based on actuarial calculations, they are less likely to die soon, so the same premium amount buys more coverage for them.)

Another name on CM Holdings' 1990 death run is Margaret Reynolds, of Uniontown, Ohio. Mrs. Reynolds suffered from amyotrophic lateral sclerosis, or Lou Gehrig's disease. In her final years, her five grown children took turns caring for her. At one point, says her son John, they begged CM Holdings for $5,000 to pay for a specialized wheelchair so they could take their mother to church. "They said it wasn't covered," Mr. Reynolds says.

Mrs. Reynolds, a $21,000-a-year administrative assistant and buyer, died in 1998 at age 62. Her family received a $21,000 benefit from a life-insurance policy provided to employees by CM Holdings. CM Holdings received a COLI payout of $180,000.

"They got what?" John Reynolds says when told. He sells life insurance himself, to small businesses, but he says he had never heard of janitors insurance. "It's mind-boggling."

For decades, a corporation or an individual wanting to buy life insurance on someone else had to have a significant financial or emotional stake in the person's survival, known as an "insurable interest." Thus, companies were able to buy life insurance on certain executives, and partners in law and accounting firms could buy life insurance on each other. The rule had evolved to prevent incentives for murder or negligence, and to discourage one person from profiting from the death of another.

But in the 1980s, insurers persuaded regulators in most states -- Texas being a notable exception -- to rewrite the rules to allow employers to buy life insurance on the lives of all employees. The practice took off as employers became aware of the tax advantages, especially the ability to borrow against the policies and then deduct the interest payments.

Federal tax law prohibits the use of life insurance as a tax shelter if there isn't a legitimate business purpose for having it. From the start, many companies have asserted that they use COLI to pay for employee benefits. Still, they aren't required to disclose how they do use COLI money.

In 1996, Congress clamped down, forcing companies to begin phasing out the interest-payment deductions they were taking on COLI loans. And the IRS began working on collecting some of the money the companies had deducted from their taxes. Some government officials say the sum under investigation is probably much higher than the $6 billion the IRS confirms, and involves as many as 700 companies.

'DEAD PEASANTS'

Like many companies, Winn-Dixie took out insurance policies on its rank-and-file workers that pay death benefits to the company when the workers die. Here's how these workers were referred to in internal company memos:

- *"Bruce -- Here is a very rough beginning of the booklet we are preparing for Winn-Dixie. A section on Dead Peasants remains to be written ... "*
- *"I want a summary sheet that has ... the Dead Peasants in the third column."*

Security and Exchange Commission filings provide some clues about the amounts of tax dollars at stake. In 2001, American Greetings Corp. recorded a charge of $143 million for potential exposure to disallowed deductions on COLI-loan interest payments. R.R. Donnelley & Son Co., a Chicago printing company, agreed this month to pay the IRS $150 million for disputed deductions related to policies covering more than 20,000 workers. And W.R. Grace & Co. indicated in its 2001 filings that it deducted $163 million in interest after 1992 and has current unresolved tax exposure of $57 million. "We believe the loans had and continue to have a valid business purpose," says a Grace spokesman, who adds that the company took out the policies to pay for benefits programs.

The courts have tended not to accept companies' rationale for using COLI. "We do not believe

that the purpose of the [plan] was to fund employee benefits," wrote Judge Robert P. Ruwe in a 1999 federal Tax Court ruling against Winn-Dixie. The Jacksonville, Fla., supermarket chain brought the case against the IRS, seeking to reinstate deductions it took on COLI policy loans covering 56,000 workers.

Judge Ruwe noted that Winn-Dixie had high staff turnover and didn't end up providing retiree medical benefits to most of its workers, while it continued to collect death benefits on those who leave the company before retirement. The judge concluded that the executives "recognized that it was a tax shelter," and that ultimately, over the 60-year life of the policies, the company hoped to save $2 billion in taxes.

In June last year, the U.S. Court of Appeals for the Eleventh Circuit in Atlanta upheld the Tax Court decision. And just Monday, the U.S. Supreme Court declined to hear Winn-Dixie's appeal. A Winn-Dixie spokesman says the company is disappointed with the high court's decision, but is "sufficiently reserved for any liability" arising from the case.

While the IRS can find out about COLI policies directly from the companies, disclosure requirements aren't tight, making it hard for others to determine just how much money is squirreled away in the insurance. Employers do, in fact, use other kinds of COLI to pay for lavish retirement benefits for executives. But disclosure rules don't require them to distinguish between executive COLI and janitors COLI.

Further, companies report all their life insurance in aggregate. Accounting rules require only that they report increases in the aggregate cash values of their life-insurance policies -- and only if the increases are "material." Materiality isn't defined.

"So, some large companies with COLI don't need to report it at all," says a former government tax official. Congress would have to ask its economists to estimate the cost to taxpayers, says another former official, J. Mark Iwry, who was chief pension regulator at the Treasury. "They'd have a hard time coming up with a number."

Big Business

Even with the phaseout of the most attractive tax breaks, COLI is still big business. Among the major marketers of COLI are Marsh & McLennan Cos. and MONY Group Inc. Marsh & McLennan itself "inherited" a policy covering an undisclosed number of employees when it acquired insurance consultant Johnson & Higgins in the mid-1990s, a spokeswoman says. She says that the company no longer pays premiums on the coverage, and that it hasn't received any death-benefit payments for its 295 employees who died in the World Trade Center on Sept. 11.

Among insurers, Hartford Life is a major COLI provider. At the end of 2001, Hartford Life had janitors insurance with a face value of $4.3 billion in force among its clients, according to its latest annual report. COLI in all its forms brought the company $37 million of its $1 billion of net income last year.

Death Benefits

How companies profited from the deaths of their employees

	Felipe Tillman	William Smith	Doug Sims	Peggy Stillwagoner
Employment	Music-store worker	Convenience-store clerk	Distribution-center worker	Home-health nurse
Died	Jan. 1992	Dec. 1991	Dec. 1998	Oct. 1994
Age	29	20	47	51
Cause	AIDS	Murdered at work	Heart attack	Car accident

Death Benefit	$339,302	$250,000	$64,504	$200,000
Paid to	Camelot Music/CM Holdings	National Convenience Stores	Wal-Mart Stores	Advantage Medical Services

Source: WSJ research

Since Congress reined in some of the tax breaks, most employers have nonetheless left their janitors coverage in force. After all, they still enjoy the tax-free buildup of value in the policies, which adds to net income. (This income is referred to in financial statements under generic headings like "other income" and "other assets.") And then the death benefits go to the company, tax-free.

These future death benefits become an "attractive off-balance sheet asset," says Albert "Bud" Schiff, president of the Association for Advanced Life Underwriting and chief executive of NYL Executive Benefits LLC, a leading marketer of COLI for executive benefits in Stamford, Conn. "Companies understand that they have this significant downstream earnings growth."

That's why they keep an eye out for the deaths of employees after they have left the company. One way they can do that is by checking the Social Security Administration's database of deaths. When AEP bought its policies in 1990, a company memo noted that "in an effort to keep the tracking of reported deceased participants of the AEP COLI plan as simple as possible," the company "would track each individual reported to us either by AEP or the Social Security sweep."

Employees rarely know about a company's plan to buy COLI policies. In some states, including California, Michigan, Ohio, Illinois and Minnesota, companies are required by law to secure employee consent to include them in coverage. In that case, the employer may offer workers an incentive of a modest amount of life insurance without charge.

That happened to Gloria Jacobs. A few years before she retired in 1993 as a benefits manager for Walt Disney Co. in Orlando, Fla., she received a letter telling her that if she agreed to be covered under a COLI program to finance employee benefits, she would receive free life insurance of $10,000. The alternative was to pay for life insurance herself. Ms. Jacobs agreed to participate.

A Disney spokeswoman declines to say how much the company will receive when Ms. Jacobs dies, nor how many employees and retirees are covered under COLI.

Even when employees are informed about the insurance, they may be unaware that the company stands to benefit more than they themselves, or that the offer of free insurance to get them to consent is not protected under federal benefits law. Employers can cancel it at any time.

Wal-Mart Stores Inc. took out COLI on about 350,000 of its workers in the 1990s, offering $5,000 in life insurance to those who agreed to be covered. Only 500 asked to be excluded, a spokesman says. The brochure that Wal-Mart gave to employees noted that the company would provide the benefits "as a result of financial gains from life insurance policies Wal-Mart will purchase ... [that] will result in the financial benefits for the corporation." But the brochure didn't make it clear that the company expected to receive a benefit far outstripping the death benefit it offered workers. "We could have communicated more," a Wal-Mart spokesman says now. In 1998, the company canceled the $5,000 benefit for workers.

Last year, Jane Sims filed suit against Wal-Mart in U.S. District Court in Houston, alleging that the company didn't have an insurable interest in her late husband, Doug, a Wal-Mart distribution center worker in Plainview, Texas, whose death at age 47 in 1998 brought $64,504 in insurance benefits to the company. The case is pending.

Doug Sims

Wal-Mart says that it ended its janitors coverage by January 2000, and that it no longer receives death benefits when employees or former employees die. The company says it "has substantially resolved" all COLI-related issues with the IRS. "We were looking to reduce our corporate income taxes," the spokesman says. "That's really why we did it. ... It was a tax strategy that didn't work out as expected."

Mrs. Sims' lawsuit is one of several filed in recent years in Texas by clients of Houston law firm McClanahan & Clearman LLP. These cases all turn on the argument that mere employment doesn't qualify as the insurable interest that Texas law requires.

That's the argument of Angela Smith. In December 1991, her husband, William, was working extra hours as a clerk at a Stop-N-Go convenience store in Pasadena, Texas, for extra Christmas money when a robber shot and killed him. He was 20 years old.

The store's owner, Houston-based National Convenience Stores Inc., didn't participate in the state workers' compensation system, which provides death benefits to families of workers killed on the job. And like others that opt out, it had taken out insurance on its clerks to protect itself from the cost of wrongful death or negligence lawsuits arising from workplace deaths. The policy, from Lloyds of London, paid NCS $250,000. The company offered Mrs. Smith and her son, Brandon, one year old at the time, a payment of $60,000 to settle any potential lawsuits, she says.

'It Seemed Like a Lot'

Mrs. Smith, who was 18 at the time and still in high school, thought the company was just being nice. "It seemed like a lot to me," she says. When she later discovered that the company would receive about $250,000 from her husband's death, she was appalled. "I can't believe they would do such a thing and make money off people," she says. "It's wrong."

William Smith

She sued NCS in state court, alleging violation of Texas' insurable-interest rules and seeking payment of the COLI money to Mr. Smith's estate. In 1999, the court awarded the estate $456,513, which included insurance, attorneys' fees and interest, according to Mike Myers, an attorney with McClanahan & Clearman, which represented Mrs. Smith.

NCS appealed that judgment. On Wednesday, NCS agreed to settle with Mrs. Smith for $390,000, McClanahan & Clearman says. Two other plaintiffs in a similar case will receive $375,000 apiece if the Smith settlement is approved in court. Valero Energy Corp., San Antonio, acquired NCS and its COLI policies last year through its acquisition of Ultramar Diamond Shamrock Corp., which had earlier bought NCS. Valero spokeswoman Joanna Weidman, noting that Valero "inherited these cases," said, "We're happy to have resolved them in the best interests of everyone involved."

In a similar case in 1998, NCS argued that it did have an insurable interest in its workers because, without workers, "NCS would not generate revenue and would cease to exist as a viable entity."

The Texas court in that case suggested that NCS consider liability insurance. It also noted: "While it may be true that NCS, like any other company, needs employees to generate revenue ... most cases addressing this issue have found that an employer does not have a pecuniary interest in the continued life of its employee, unless that employee is crucial to the operation of the business."

"Crucial" is an abstract term. But it isn't difficult to see that many people covered by COLI policies play little role, if any, in the companies that benefit from their deaths: part-timers, for instance, and retirees.

In 1994, Rusty Stillwagoner, a police officer in Sulphur Springs, Texas, got a call from the dispatcher saying that his mother, Peggy, had been in a bad accident. Mrs. Stillwagoner, a nurse, was driving to her next home-care appointment when another driver slammed into her Geo Metro. At the hospital, Rusty Stillwagoner found the paramedics performing CPR on his mother. The 51-year-old Canadian immigrant underwent emergency surgery, but she died soon afterward.

Peggy Stillwagoner

Facing tens of thousands of dollars in medical bills, Mrs. Stillwagoner's family asked her employer, Advantage Medical Services Inc., if it provided any life insurance or other benefits. The owner of the company, Ron Lummus, "'tearfully' denied the existence of any insurance covering Peggy," a Texas appeals-court judge later wrote.

A few months after the accident, an insurance-company investigator called Mrs. Stillwagoner's husband, Kenneth Stillwagoner, asking him to sign papers releasing her medical records. When the family returned the investigator's call, they learned that Advantage Medical Services held a $200,000 insurance policy on Mrs. Stillwagoner's life. "My father blew his top," says Lt. Stillwagoner, who, like several other family members, had worked for Mr. Lummus at one time or another. "We were pretty shocked."

The family sued in state court in Hopkins County, arguing that the company had no insurable interest in Mrs. Stillwagoner's life and seeking the death benefit the company had received.

She was, after all, just a temporary employee who had been with the company for two months, and who was replaced the day after her death.

The family lost and appealed. The company insisted that it did have an insurable interest, because the field nurse had the "opportunity to attract or create new business and was therefore a valuable employee," the Texas appeals court noted.

In late 1998, the appeals court reversed the lower court's ruling and found that Kenneth Stillwagoner had a right to challenge the insurance payment to Advantage Medical Services. Subsequently, the company and Travelers Insurance Co., a unit of Citigroup Inc. that sold Advantage the coverage, settled with the family for $395,000.

A spokeswoman for Travelers declined to comment. Carl D. Bryan, who represented Mr. Lummus and Advantage Medical, says the accidental-death policy was a rider that came with a policy the company had bought to pay wages for employees injured on the job, not a policy the company took out separately. Mr. Lummus "wasn't trying to hide the fact that there was insurance -- he didn't even know there was [life] insurance." In any case, Mr. Bryan adds, "if a company pays the premium, why shouldn't it benefit from the policy?"

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