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**TOPIC:** Dispute Over Section 1035 Paperwork Leads to Processing Delay and Litigation

**CITATION:** [Branch Banking and Trust Company v. Pacific Life](#), Case No. 14-5871 (6<sup>th</sup> Cir, Apr. 12, 2016).

**SUMMARY:** The trustee of an irrevocable life insurance trust (ILIT) sought to exchange a Pacific Life trust-owned variable life (VL) insurance policy under Code Section 1035 for new coverage to be issued by John Hancock. A home office employee at Pacific Life decided that the paperwork was inadequate to initiate the exchange due to a technical error, and the process was delayed. During the time the change was delayed, the cash value of the VL contract decreased by nearly \$260,000.

After finishing new exchange paperwork under protest, the trustee sued Pacific Life in federal court for the lost cash value. After some back-and-forth between the trial court and appeals court, a trial was held and the jury decided in favor of the trustee. The federal appeals court for the sixth circuit affirmed that verdict.

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**RELEVANCE:** The amount of detailed paperwork needed to submit a life insurance case can frustrate even seasoned agents. On the other hand, if the life insurance company is not provided all the information it requires and needs to properly evaluate a risk and issue a policy, that fact should rightfully delay the process of issuing a policy.

When a Section 1035 life insurance exchange case is submitted, in addition to the paperwork associated with new business, there are other documents needed in dealing with surrendering and transferring values from one or more existing policies to the new one. The extra processing—and different and sometimes multiple employees involved from more than one home office—often leads to communication breakdowns, confusion, and delay.

In this case, one home office employee's decision regarding the technical adequacy of a single piece of paper stopped the Section 1035 exchange process. That delay meant the policy owner lost more than a quarter of a million dollars and had to go to the trouble and expense of suing to recover it.

The facts of this case serve to remind professional agents about the importance of taking time to:

- Identify all the paperwork required to submit a case,
- Accurately and completely provide all needed information,
- Secure all signatures required,
- Read the carrier's directions to be sure all formalities are strictly followed, and
- Follow up and stay with the exchange process until it is completed expeditiously.

**FACTS:** Branch Banking & Trust (BB&T) was the trustee of the Charles and Elise Brown ILIT, originally funded with a Pacific Life variable life insurance policy with a death benefit of \$12.83 million. In 2008, Walter Koczot, the BB&T trust officer for the ILIT, decided to replace the Pacific Life policy with a similar policy from John Hancock.

Koczot assigned the Pacific Life policy to John Hancock. On September 8, 2008, Jonathan Squire of John Hancock sent a request letter to Pacific Life and attached a copy of a Section 1035 assignment form as proof of John Hancock's ownership and Squire's authority to request surrender and receive the proceeds.

Pacific Life received Squire's surrender request letter at its Home Office on September 9, 2008. On that day, the policy's cash value was \$779,818.19.

A Pacific Life employee received Squire's letter and treated it as a typical Section 1035 exchange letter. However, because she did not have Koczot's signature on file and because Koczot's signature on the assignment form had neither a notarization nor a corporate seal, she decided that the Section 1035 assignment was not satisfactory.

The Pacific Life employee sent two form letters by regular mail. The first letter was sent to Koczot, letting him know that she had received the surrender request but not mentioning her refusal to surrender the policy. The second letter was sent to John Hancock's home office, advising them that she would not process the surrender request until she received "the signature of a corporate officer for Branch Banking & Trust Company, as trustee to include title and corporate seal or notary." Because she did not copy Squire, Koczot, or anyone at BB&T, they remained unaware of this demand for additional authentication.

Meanwhile, the stock market was crashing. On October 1, 2008, Koczot and Squire discovered that the policy had not been surrendered as requested. On that day, the policy's cash value was \$723,655.55, \$56,162.64 less than the September 9 value.

BB&T asked Pacific Life to process the Section 1035 Exchange using the September 9 cash value, but Pacific Life refused. Eventually, on December 11, 2008, BB&T sent a new surrender request, with the notarization and corporate seal, while also reserving its right to sue for the difference. Pacific Life executed the exchange the next day. The policy's cash value on that day was \$519,891.86; \$259,926.33 less than the September 9 value.

BB&T sued for breach of contract on its theory that the policy required Pacific Life to send to it—the trustee—notice of Pacific Life's rejection of the Section 1035 paperwork. Pacific Life responded that BB&T had assigned the policy to John Hancock, so John Hancock was the owner on September 9 and Pacific Life had properly notified the owner of the rejected paperwork.

The trustee amended its complaint to conform to the idea that Hancock, not the ILIT, owned the policy on September 9, 2008. BB&T then filed a motion for summary judgment, which the district court granted. In granting the motion, the district court decided that it would have been impossible for a reasonable person to decide that Pacific Life did the right thing in rejecting the policy assignment paperwork.

The Sixth Circuit Court of Appeals reversed the decision of the lower court, ruling that a jury might find that Pacific Life's rejection of the Section 1035 paperwork was reasonable under the circumstances. It sent the case back to the district court.

The case was decided by a jury, which found that Pacific Life's refusal to process the Section 1035 exchange on September 9, 2008 was unreasonable. It awarded damages to the ILIT for the nearly \$260,000 of account value lost while the exchange was in limbo. Pacific Life appealed, but the Sixth Circuit affirmed the result.

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