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White Paper

Life Insurance Policy Provisions

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Life Insurance Policy Provisions

What are life insurance policy provisions?

Life insurance policy provisions describe or explain various features, benefits, and conditions of your life insurance policy. Provisions in your life insurance policy also stipulate the rights and obligations of both the insurer (insurance company) and the insured (you). Every life insurance policy contains numerous provisions.

Most states have laws requiring certain provisions to be included in life insurance policies and prohibiting the inclusion of other provisions. Examples of provisions commonly required by law are the free look, the grace period, the incontestability clause, and the reinstatement provision. Certain provisions (such as the designation of beneficiary and entire contract clause) are found in every life insurance policy, regardless of the type of policy or the state in which it is issued. Life insurance policies also typically include an assortment of optional provisions that either you or the insurance company may choose to include in the contract. You should consult additional resources to determine the best combination of policy provisions, options, and riders for your specific situation.

Common policy provisions

Assignment clause

An assignment shifts all or part of the rights in a life insurance policy from the policyowner to another person or institution. The assignment clause in a life insurance policy usually allows you to freely assign the policy.

Example(s): Suppose you take out a loan at your bank and the bank wants you to use your life insurance policy as collateral. The assignment clause would allow you to assign the policy to the bank. If you die before you pay off the loan, the bank would receive enough of your life insurance policy death proceeds to cover your outstanding loan balance. The remaining death benefits would be paid to your beneficiary.

Automatic premium loan provision

This clause provides that if the policyholder fails to pay the premiums on a life insurance policy, the insurance company may automatically use the accumulated cash value to pay the premiums. The primary purpose of this provision is to prevent the unintentional lapse of your policy. Money loaned to the policyholder through an automatic premium loan is treated like any other loan against the policy's cash value. This means that interest will be charged on the loan, and any outstanding loan balance will reduce the death benefit.

Aviation exclusion

This provision restricts payment of benefits if your death results from aviation activities, unless you were a paying passenger of a regularly scheduled commercial flight. If, for example, you were killed as a pilot or passenger in a private plane crash, this exclusion would apply, and your beneficiary would not receive the death proceeds of the life insurance policy. At one time, this exclusion was part of almost every life insurance policy. Today, most policies cover such losses, although additional premiums may be required to cover private pilots.

Bailout provision

Some life insurance policies impose surrender charges if the policy is terminated before a specified period of time has passed to recover expenses incurred during the issuance of the policy. A bailout provision reduces and in many cases eliminates these surrender charges. This provision enables you to withdraw your money or terminate your policy without penalty. However, you can typically invoke your rights under the bailout provision only if the insurance company fails to meet a certain standard—for example, if its interest rate falls below market standards.

Beneficiary designation

When you purchase a life insurance policy, you must decide who will receive the death benefits of the policy when you pass away. The beneficiary clause permits you to name this beneficiary. Your beneficiary must outlive you in order to receive the proceeds from your life insurance policy. Thus, it may be wise to also designate a secondary (or contingent) beneficiary who will receive the death benefits of your policy if the primary (first-named) beneficiary dies before you. You can typically change your beneficiaries at any time by writing to your insurance company and completing the appropriate paperwork. However, there are circumstances under which you might choose to name an irrevocable beneficiary. In this case, you would not be able to change the beneficiary, and you would give up other ownership rights, such as the ability to take a loan against the policy without the consent of the beneficiary.

Tip: Your beneficiary can also be an institution, your estate, or a minor child, although naming these parties as beneficiaries can present certain complications. For more information, see Life Insurance Ownership and Beneficiary Designations.

Common disaster provisions

Also called the survivorship clause, this provision states that your primary beneficiary must outlive you for at least a specified period of time (typically between 10 and 30 days) in order to receive the proceeds of the insurance policy. Otherwise, the proceeds go directly to the contingent beneficiary. The purpose of this provision is to protect the rights of the contingent beneficiary in cases where you and your primary beneficiary die simultaneously or nearly simultaneously.

Contract change provisions

There are three different provisions that allow you to make changes to the life insurance contract: the change of owner provision, the change of plan provision, and the change of insured provision.

- Change of owner--The change of owner provision allows you to transfer ownership of your life insurance policy by making an absolute assignment. An absolute assignment means that you transfer all rights in your policy to another person or nonperson entity without any conditions attached.
- Change of plan--The change of plan provision gives you the privilege of exchanging your life insurance policy for another policy issued by your insurance company. A cash value life insurance policy can typically be exchanged for another cash value policy, while term insurance can typically be upgraded to a permanent cash value policy. The advantage of this provision is that the new policy typically has the same policy date, underwriting class, and issue age that your original policy had. Thus, your premiums will typically be lower than if you terminated your old policy and took out a new policy. However, you may have to contribute additional money to your cash value to make up for cash value amounts that would have accumulated in the earlier years of the cash value policy.
- Change of insured--The change of insured provision permits you to exchange a life insurance policy on one life for a similar life insurance policy on another life. You will typically have to provide evidence of insurability on the new insured person before a new policy will be issued. This type of transaction is typically less expensive than terminating the policy on your life and buying a new policy on the other person's life, because you can avoid surrender charges, commissions, and other fees.

Entire-contract clause

Every life insurance policy contains an entire-contract clause. This clause stipulates that the life insurance policy, together with a copy of your application, constitutes the entire contract between you and the insurance company. It also stipulates that there are no other outstanding agreements between you and your life insurance company. This provision ensures that there are no misunderstandings between the insured and the insurer regarding the rights and responsibilities of each.

Free look

Most states require insurance companies to provide a no-obligation examination period (commonly 10 days), beginning the day you receive the policy. If you decide to cancel the policy during this examination period, you would be entitled to a full refund of any premiums you paid. If you die during the free-look period, your beneficiary will receive the policy's death benefits, unless you had returned the policy for a refund.

Grace period

If you fail to pay your premium by the due date, you typically have a short time frame in which to do so before the policy lapses. Commonly called the grace period, this time frame is generally 30 or 31 days. As long as you pay your premium before the end of the grace period, your policy will remain in force with no penalty. If you die during the grace period, your beneficiary will receive the full value of the death proceeds of your life insurance policy minus any premium that is owed to your life insurance company.

Hazardous occupation or hobby exclusion

This provision states that no death benefit will be paid if you die as a result of your dangerous career or hobby (e.g., skydiving). Although this clause is not automatically included in most modern life insurance policies, you may have to pay a higher premium if you fall into certain high-risk categories.

Incontestable clause

Once your life insurance policy has been in force for a certain period of time (typically two years), the insurance company cannot contest or void the policy except for nonpayment of premiums. If the insurance company discovers some reason to contest or void the policy, it must take action before the end of the contestable period. Once the end of the specified period is reached, the policy generally cannot be voided.

Misstatement of age/sex clause

Age and sex are both factors in determining the cost of any given life insurance policy. If you understated your age or lied about your sex to obtain a lower premium, the insurance company has certain rights upon discovering such a misstatement. If you are alive when the misstatement is discovered, the insurance company can adjust the amount of your future premiums and demand payment of the additional premiums you should have paid before the misstatement was discovered. If the misstatement is not discovered until after you die, the insurance company must compute the amount of insurance your premiums would have purchased for someone of your actual age or sex and pay your beneficiary that amount.

Ownership provision

The ownership provision in a life insurance policy specifically names the owner of the policy. This is particularly important when the owner of the life insurance policy is someone other than the insured (e.g., when a wife is the owner of an insurance policy on her husband's life).

Payment of premiums provision

This provision states that you must pay your premiums as they come due in order to keep your policy in force. If you do not pay your premiums for your life insurance policy, this non-payment may cause your

policy to lapse. If your policy lapses, the reinstatement provision may allow you to restore your policy by paying back premiums and interest.

Policy loan provision

The policy loan provision stipulates the amount you can borrow against your cash value, the rate of interest, and other terms for policy loans. In the event that you die with policy loans outstanding, your insurance company will deduct the unpaid amount plus any accumulated interest from your death benefit.

Policy loan provisions are found in most cash value policies. If you own a term life insurance policy, there is no cash value to borrow. Thus, the policy loan provision does not apply.

Reinstatement provision

A reinstatement provision requires the insurance company to reinstate a lapsed policy if you request it within a certain period. The reinstatement period is typically three years from the date of your last premium payment. Before your policy is reinstated, the insurance company can require you to pay all back premiums with interest and provide proof of insurability. This means you will probably have to take a medical examination to prove you are in good health. Even though it may be expensive, this can be an attractive option because, based on your age, you might have to pay much higher premiums for a new policy.

Renewability provision

This clause in a term life insurance policy allows you to renew the policy without having to take a medical examination or provide proof of insurability, regardless of your physical condition at the time of renewal. However, your premiums will increase upon renewal to reflect your life expectancy at your current age.

Spendthrift provision

A spendthrift provision is designed to protect the proceeds of the policy against the actions of an irresponsible beneficiary. The spendthrift provision provides that proceeds will not be paid in a lump sum and that money that is not immediately paid to the beneficiary will be held by the insurance company, where it will be safe from any creditors of the beneficiary. The spendthrift provision also prohibits the beneficiary from assigning the payments to a creditor or borrowing against the proceeds.

Suicide clause

This clause stipulates that if you commit suicide within a specified time after purchasing the policy, no death benefits will be paid. The time period is typically two years from the date you purchase the policy. If you were to commit suicide during this period, no death benefits would be paid, but any premiums you had paid would typically be refunded.

War or military service exclusion

This provision typically stipulates that there will be no payment of insurance policy proceeds if your death is the result of a declared war. The exclusion may also be written to restrict payment of proceeds for any death that occurs while the insured is serving in the military.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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