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LIFE SETTLEMENTS: ANALYZING THEIR STRUCTURE AND REGULATORY ENVIRONMENT

CCH: Could you tell us briefly, what is a life settlement, who are the parties involved and how is the typical transaction structured?

Life settlements have become an increasingly popular way of extracting value from unwanted life insurance policies. In the following interview, Larry Simon, CEO, president and director of Life Settlement Solutions, Inc., based in San Diego, CA, discusses life settlements, state regulations regarding these transactions and anticipated trends for the life settlement industry. Mr. Simon is the founder of Life Settlement Solutions, Inc., an institutionally funded, direct purchaser of life settlements, and has authored numerous articles pertaining to life settlements.

afford their coverage. Instead of selling the policy back to the originating insurance company at less than market value, or allowing the policy to lapse and forfeiting the value, life settlements provide another exit option that maximizes value for the policy owner.

The parties involved are typically the client, his or her advisors (who often include the insurance agent, attorney or CPA), a settlement broker and the settlement providers who represent the institutional investment capital. The transaction is structured in a manner in which the client's policy is evaluated and pricing proposals are obtained from several providers based on the characteristics of the life insurance policy being sold and the medical condition of the insured. The providers' bids are evaluated by the client and his or her advisors to determine which offer best meets the client's needs. Once accepted, contracts are executed to transfer ownership

of the policy to the investor and funds are transferred to the seller. The investor then has the obligation to make future premium payments and ultimately collects the benefit when the policy matures.

CCH: What is the difference between a life settlement and a viatical settlement?

Mr. Simon: The life settlement industry was born out of the viatical settlement concept. However, there is quite a distinction between the two industries. Whereas viatical settlements are related to terminally ill insureds, life settlements are conducted for only those insureds who do not suffer from any terminal illnesses or have chronic or catastrophic medical conditions.

CCH: Who is the typical or target client for a life settlement?

Mr. Simon: The life settlement market is for policies where the insured is age 65 and older. However, the typical candidates are males age 72 or older and females age 75 or older. Most providers have minimum face amount requirements that range from \$100,000 to \$250,000. Certain providers, including our firm, have no upper limit on the face amount per insured. The type of policies transacted most frequently are universal life policies, including variable universal life, as well as convertible term insurance and survivorship policies.

INSIDE

Life Settlements: Analyzing Their Structure and Regulatory Environment	33
Stock Value Fixed Under Buy-Sell Agreement	38
Fiduciary Duties and Liabilities Examined	39

CCH: Who are the typical purchasers of policies from life settlement companies and why?

Mr. Simon: Policies are typically purchased by institutional investors, who are becoming involved in the life settlement market for a number of reasons:

- Above-LIBOR (London Inter-Bank Offer Rate) returns due to the inefficiency in surrender values;
- Low volatility due to restrictions on the health and medical conditions of the insured;
- A long-term investment;
- Minimal-gap risk;
- The credit risk associated with insurers can be managed by purchasing policies with A-rated carriers;
- Additional portfolio diversification, enhancing fund stability and returns; and
- No significant correlation to traditional asset classes such as equities, currencies and commodities. However, there is correlation to interest rate markets.

CCH: What is the current aggregate market for such policies and what factors are influencing this market?

Mr. Simon: A June, 2005 Bernstein Research report titled "The Long View: 2005 edition—U.S. Perspectives," projected the life settlement market at \$10 to \$12 billion in aggregated face amount in 2005. During the course of the next year, it is anticipated that life settlements will account for nearly \$15 billion of face amount.

Several factors are influencing the market. As the industry has matured, major institutions have entered the industry as investors. As traditional asset class investment returns have fallen during previous years, investors have been seeking alternative investments in the life settlement industry. The entry of these firms has supplied large amounts of lower cost capital, which has increased the average purchase price of policies. Financial professional awareness and knowledge of the industry is still quite low but is now growing rapidly and fueling increasing amounts of product available for purchase.

The industry is nearly ten years old, but has really picked up speed within the past five years. The catalyst for the major industry growth is education. A recent study (*Life Settlements Poised for Growth*, AGENT'S SALES JOURNAL, March 2006) showed that 80 percent of insurance producers have never transacted a life settlement, simply because they have not had enough education about the

transaction. In response to this lack of education in the industry, I am proud to announce that Life Settlement Solutions has declared June to be Life Settlement Awareness Month. We will be holding educational webinars that will provide opportunities for estate planners to learn about the industry. A schedule of activities can be found at www.lss-corp.com or www.lifesettlementawarenessmonth.com.

CCH: Are there certain types or characteristics of policies that would make them better suited for a life settlement than others?

Mr. Simon: The most important characteristic is whether the policy is unneeded or underperforming. The type of policy most suited for a life settlement is a universal life policy.

CCH: What factors may affect the amount paid for a policy?

Mr. Simon: As for the policy itself, factors that affect settlement values include the face amount, the cost of insurance (premiums), the cash surrender value of the policy and the life expectancy of the insured. Policies with little cash value and increasing premium requirements due to underperformance tend to be major factors in a client's decision to sell a contract in the secondary market.

CCH: How does a potential seller know whether they are receiving what they deserve in a life settlement, and is it possible to "shop around" for the best deal?

Mr. Simon: In order to provide clients with the best possible offer and meet their fiduciary responsibility to their clients, producers should shop each case to at least three major providers or use a qualified settlement broker who will obtain offers from multiple providers. Evaluation of multiple pricing offers is the most effective

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strategy in determining if a client is receiving the best offer in the marketplace.

CCH: Are life settlement companies rated or ranked and, if so, by whom?

Mr. Simon: Yes, the German rating agency Scope Group provides ratings of life settlement providers.

CCH: What are the obligations of the estate planning practitioner when a client is contemplating a life settlement?

Mr. Simon: The first obligation is to assess the client's needs and determine if his or her existing insurance coverage still meets those needs. If a settlement is considered, the estate planner must either possess or obtain the knowledge on how to properly obtain the market valuation of the client's insurance contract(s). If estate planners do not know how to do that, then they need to work with a firm who has expertise in this area. In addition, when new, more appropriate insurance is being purchased, the estate planner must be able to ensure that the client has received approval on the new insurance coverage before the existing insurance is sold in the secondary market. The estate planner must be aware of all applicable state laws on life settlements and ensure that the transaction is handled in a compliant manner.

CCH: Once the sale is completed, is there any follow-up contact between the seller and the settlement company?

Mr. Simon: Once a settlement transaction is completed, the insured agrees to periodic contact either directly or through his or her physician to monitor his or her status. The investor pays premiums until the policy matures and then ultimately receives the benefits.

CCH: Generally, what are the tax ramifications of a life settlement?

Mr. Simon: All clients need to consult their tax professionals to determine their specific tax liabilities. However, there are generally three tiers of proceeds from settlements. Proceeds received up to the cost basis in the policy (premiums paid) are treated as a return of capital and are not taxed. If the cash surrender value is greater than cost basis then the proceeds received equaling the difference between cash surrender value and basis are treated as ordinary income—just as they would if the policy were surrendered to the insurance company. Settlement proceeds above cash surrender value are typically treated as capital gains.

CCH: What does the current overall regulatory environment look like?

Mr. Simon: More states are reviewing their laws, and we should see more consistency in the patchwork of states where life settlements are regulated, the state departments of insurance or securities set forth the bulk of applicable regulations. At this time, approximately 39 states have some form of regulation for viatical or life settlements, including minimum payouts (as a percentage of face value) in some states. According to the Bernstein report, approximately 15 states allow agents with standard life insurance licenses to negotiate life settlements on behalf of clients interested in selling their policies, while other states require a separate settlement broker's license. The authors of the Bernstein report contend that, according to industry insiders, the lack of licensing in other states does not prevent life settlements from taking place. Instead, "it could give rise to poor-quality transactions that may or may not benefit policyholders." Further, "another issue is whether underwriters need to be registered with insurance regulators, which again appears to vary by state."

For years, leaders in the life settlement industry have worked closely with the National Association of Insurance Commissioners (NAIC) for consistent regulation of life settlements.

CCH: Have any states enacted legislation or adopted regulations specific to life settlements?

Mr. Simon: Various states have enacted laws related to life settlements. Producers should refer to their own state's laws when transacting a life settlement. There are approximately 39 states with some form of regulation covering areas such as licensing, definition of a life settlement, and requirements that an insured must meet to be considered a settlement transaction. A terrific resource to research up-to-date state statutes, key definitions, regulations, and disclosures can be found on the "settlement requirements" page of the Life Insurance Settlement Association's web site, located at www.lisassociation.org.

CCH: Are there any particular issues with respect to life settlements that are receiving more attention from state regulators?

Mr. Simon: Most of the attention is related to enacting more consistency across the states on life settlement licensing and transactions. Compensation paid to intermediaries has received increasing attention and is something that estate planners should evaluate when reviewing a settlement transaction. Among the issues receiving the attention of legislators and regulators throughout the country are:

Facilitating change of policy domicile may be viewed as fraudulent. Proposals for legislation prohibiting change

of ownership of a policy or change of residency of a seller, if done to avoid regulation in a particular state, have been discussed for adoption in a few states. Some proposals are limited to change in domicile of in-force policies (aimed at settlements) while other states are considering application of similar principles to prohibit the initial issuance of a policy in one state for an insured who resides in another state, if done for the purpose of avoiding regulation or laws in force in the insured's state of residence. For example, Florida has amended its viatical/life settlement laws to make it a crime, punishable as a felony, to "knowingly or intentionally facilitate the change of state of residency of a viator to avoid [Florida settlement laws]" (Fla. Stat. § 626.99275(1)(d)).

Insurer disclosure proposals. Settlement brokers and providers have typically been required to provide written disclosures to policy owners and insureds regarding certain risks or potential disadvantages of a settlement transaction. Proposals are currently circulating in some states that would require insurance carriers to provide written notice to certain policy owners regarding the advantages that might be offered through a settlement transaction. Under some proposals, the carrier's disclosure obligations would be triggered by specific events, such as including disclosures whenever a lapse notice is sent to the policy owner, or upon receipt by the carrier of an indication that the policy owner seeks to cash in a policy for its surrender value, or inquiries regarding the availability of accelerated death benefits.

Broker commission disclosures. It is expected that more states will move toward requiring express disclosure of the amount and method of calculation of commissions paid to settlement brokers and agents in connection with settlement transactions. The primary argument in favor of such disclosure is that it is consistent with the concept that the broker/agent acts as the fiduciary representative of the seller and fiduciaries have long been held to a high standard of full disclosure. Some large distribution networks are voluntarily disclosing commissions and placing caps (around six percent) on commissions to maximize their ability to provide a higher value of service to their clients.

Insurable interest. The legal concept of "insurable interest" is based on the question of what the policy owner stands to lose upon the death of the insured (not what they will gain through recovery on the policy). Insurable interest is the loss flowing from the death of the insured that a life insurance policy is designed to cover.

- Spouses, dependents and other close family members are presumed to have an insurable interest based on their relationship with the insured.

- Business entities, even family owned companies or family partnerships, do not enjoy any such presumption, but must instead show that the insured is a "key person" in the operation of a business enterprise, the loss of whom would have an adverse economic impact on the company.
- Insurable interest is determined by the relationship between the insured and the original owner of the policy at the time the policy is issued.
- The lack of an insurable interest at the inception of the policy renders a policy void.
- In many states, an insurable interest defense survives expiration of the contestability period and can be asserted by the carrier at any time during the term of the policy or after death of the insured, against either the original owner or any subsequent owner of the policy.
- Legislators are expected to continue ongoing discussions of proposals to either expand or contract insurable interest rules in various states.

CCH: Have there been any model or uniform laws proposed?

Mr. Simon: In 1992, the NAIC, a voluntary organization comprised of insurance regulatory officials from all states, developed the Viatical Settlements Model Act, which would require companies and brokers to obtain a license before entering into viatical settlement agreements. The model act was revised in 2002. Several states have adopted the model act, and others have implemented certain provisions of the act in enacting regulations.

In 2004, the NAIC published a model regulation for viatical and life settlements, under which licensed life insurance agents who recommend settlements would not be required to have a separate settlement broker's license, thus making it easier for them to advise clients regarding life settlements. At the same time, the National Council of Insurance Legislators supported similar efforts to not require separate licenses.

Today's version of the act also includes clauses protecting against fraud and gives states the option of addressing sales to investors. While the NAIC recommendations are not law, they were developed to encourage states to adopt uniform standards to regulate the evolving life settlement industry. Legislation based on the model act is pending in California, Illinois and New York, among other states.

CCH: Is there a specific state or states that present a particularly favorable (or unfavorable) jurisdiction for a life settlement and, if so, is it possible to effectively forum shop?

Mr. Simon: A few states have very restrictive laws that make it difficult for a settlement provider to purchase policies in a way that would be economically beneficial to both the seller and the provider. There is also a wide range in the level of difficulty, time and costs involved in obtaining licenses in various states. However, forum shopping is generally not encouraged and could result in unintended tax or legal consequences for the seller. As mentioned before, some states expressly prohibit change of domicile of a policy if done for the purpose of avoiding the state's settlement laws.

CCH: Please comment on two points raised in a recent article in *The Wall Street Journal* on life settlements (May 2, 2006; page C.1), specifically (1) the prevalence and impact of nonrecourse premium financing and (2) the possibility of regulators imposing a required holding period to reduce speculation.

Mr. Simon: I expect to see a substantial increase of premium-finance paper in the market later in 2006, though a portion of the premium-finance paper will have difficulty being placed in the secondary market due to ownership and insurable interest issues, as well as the structure of the underlying premium finance programs. With respect to required holding periods, marketplace factors have already had an impact on issues related to premium financing and speculation. Most insurance carriers have increased their review of policies being financed, with an emphasis on insurable interest and the reasons for the amount of insurance. The settlement industry has an equally strong interest in ensuring that proper insurable interest and needs are present. The settlement industry has a positive impact to the consumer and to the underlying value of life insurance perceived by the consumer. By supplying a valuable alternative to cash surrender, consumers have an option to sell in a competitive marketplace, just as they have for virtually any other asset they own. The solution to these issues will result from the marketplace as well as from regulation, and I welcome any regulation that addresses the issue of speculation without curtailing the consumers' ability to receive the fair market value of their contracts.

CCH: Do you see any significant changes or trends in the life settlement industry in the foreseeable future?

Mr. Simon: In 2006 and beyond, the huge population of baby boomers will enter retirement, fueling the growth of the life-settlement industry. U.S. citizens over age 65—the target age group for life settlements—will continue to grow by more than three times the rate of growth for the entire population. As this population enters its retirement years, it is estimated there will be about \$100 billion in life insurance coverage in the marketplace. With the increase in the retirement age population, life settlements will continue to grow as a viable means of financial planning. More brokers and financial planners will realize they have a fiduciary duty to their clients to disclose the benefits of life settlements to clients with unneeded policies.

Industry competition will run parallel with industry growth, and advisors should insist on working with market players who are reputable. They should perform due diligence by gathering information from several competitive life settlement companies and by targeting those whose senior management has had the most life settlement experience, that work solely with institutional investors and that have no history of regulatory or customer complaints.

With institutional investors' increasing appetite for life settlements as an asset class, funding will likely shift from German private equity sources to large banks, hedge funds, pensions, derivatives and fund of funds. In the next few years, the major source of capital will come from term securitization. So far, though, I have seen unrated securitization around the world, and there is no term securitization rating by Moody's or Standard & Poor's Register of Corporations. I see this occurring within three years.

Investors' confidence was also recently bolstered by the Financial Accounting Standards Board's recent change in its accounting rules, allowing investors to carry the asset value of purchased paper at purchase price rather than the much lower cash-surrender value.

Finally, regulation of the industry will continue to impact the growth of the life-settlement industry—boosting the confidence of eligible policyholders and investors alike.

CCH: Are there any sources you would recommend for keeping current on state regulation of life settlements?

Mr. Simon: The national organization for life settlements is the Life Insurance Settlement Association. Their website is www.lisassociation.org. ♦