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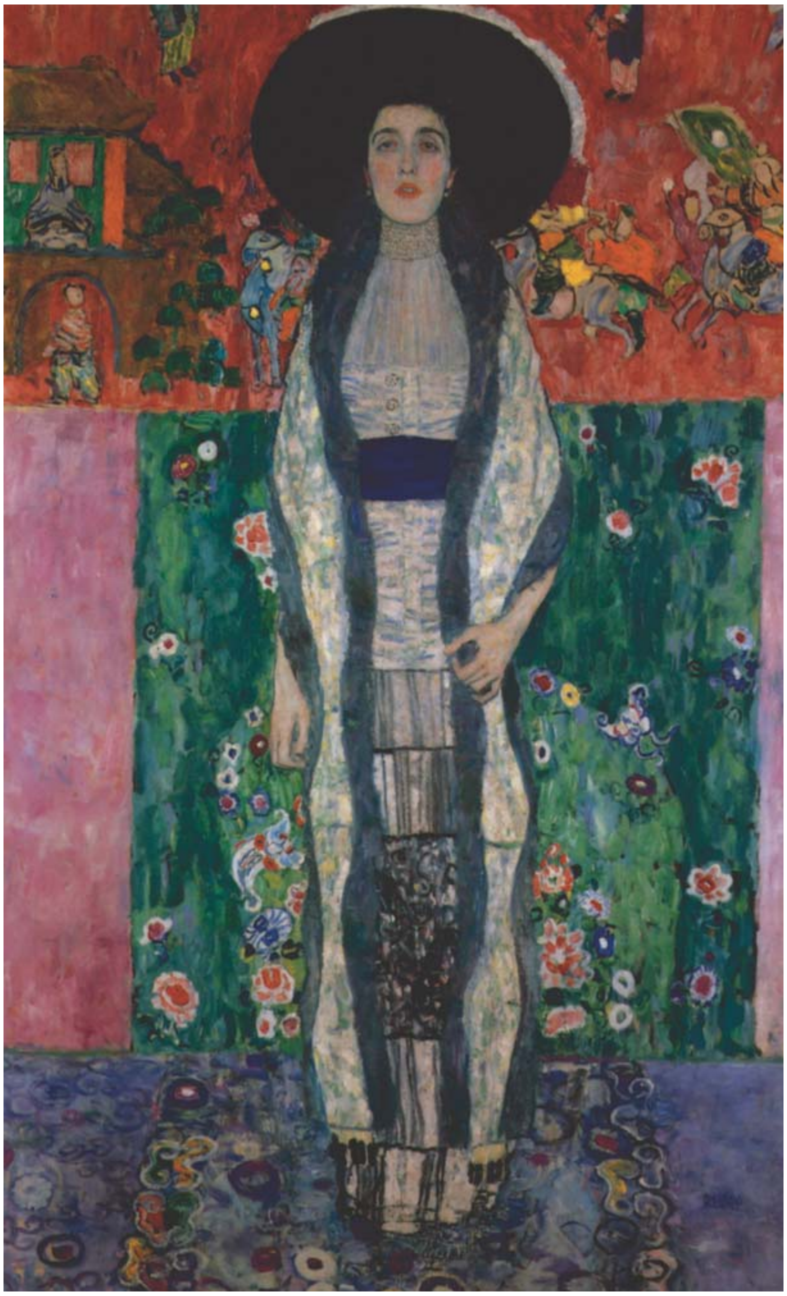


Nazi-Seized Art Returned—"Adele Bloch-Bauer II" goes to its rightful heirs, p. 6.

Sell Your Policy?

A life settlement provides liquidity. But determining whether it's the right choice and negotiating the sale are fraught with pitfalls

By **Allan Goldstein**, chief executive officer, **Leigh Harter**, managing director and **David Holaday**, associate, The Insurance Design Center, LLC, Deerfield, Ill.

Who should consider life settlement as one alternative to managing life insurance capital?

When is a settlement a wise decision? What factors should be considered before selling a life insurance policy? Who will benefit from a settlement? Have most of the possible outcomes been considered?

These are all difficult questions with no right answer.

A life settlement[1] is defined as the sale of an existing life insurance policy to a third-party for an amount greater than the policy's cash surrender value and less than the death benefit. This alternative market for life insurance policies began to emerge in the early 1990s as institutional investors (such as hedge funds, banks and pensions) recognized that buying and maintaining policies on older insureds could produce returns in excess of 10 percent on capital. Since 1998, the life settlement market has acquired over $13 billion in face amount of policies[2] and experienced an approximate 19 percent compound annual growth rate.[3]

Clearly, while some clients might cringe at the thought of a stranger owning an insurance policy on their lives, others see it as a viable economic option. In fact, life settlements are now an important alternative for trustees, businesses and individuals to turn to for additional leverage.

Yet not everyone need apply. Policies under $250,000 of death benefit, unless part of a larger portfolio, may be too small for the settlement market. Anecdotal information from a number of life settlement insiders indicates an average death benefit per transaction of between $1.5 million and $2 million (transactions typically include more than one policy) and an average multiple offered for cash surrender value of between two and four times cash value. The negotiated value of life settlements varies widely based upon the insured's life expectancy, projected funding, carrier ratings, type of contract (term, whole life or universal life), cash value, death benefit and interest rates. In most cases, third parties will acquire only policies that are beyond the initial two-year contestable period to avoid the possibility of the insurance company rejecting the death benefit claim. There is some debate now about the insurable interest of third-party purchasers of insurance contracts.

If premiums for the existing insurance are still affordable, surrender for cash value is not the only alternative to settlement. A May 2005 study by Deloitte Consulting LLC of all life settlement sales from 2000 to 2003[4] estimated that the loss to estate value (that is to say, the percentage of the death benefit that would have been available at the projected life expectancy—adjusted for premiums paid and discounted for time value of money—versus alternative investments for the settlement amount) varied between 52 percent and 81 percent on average, depending on various assumed investment rates and life expectancies. "The potential yield of a life insurance contract when the policyholder's health has deteriorated is so great that other creative options to preserve the contract should be explored before making any decision to sell a contract," Deloitte concluded.[5]

Understanding how a life settlement transaction proceeds and how to pursue a profitable outcome, as well as when it is more sensible to advise clients not to sell, should be every advisor's goal when they are reviewing the prospective sale of life insurance coverage.

FIRST THINGS FIRST

The first question is, of course, what triggers a discussion of a life settlement? With individuals and trusts, it generally happens when someone is considering the surrender of coverage; there's a change of economic circumstances including bankruptcy, divorce, or retirement; an estate's liquidity needs have diminished; or during the restructure of an insurance portfolio when a policy can be sold for greater net cash value than current cash surrender value, with proceeds used to obtain more efficient coverage. With businesses, consideration of a life settlement occurs when a company is sold; at the retirement of an individual who's insured in a buy-sell agreement or key-person plan; and upon termination of a split-dollar agreement.

The three primary administrators of any life settlement transaction are:

• *the settlement agent,* who should be a licensed life insurance agent in the state in which the policyholder resides, and qualified to review the policy regarding its ongoing suitability for retention, surrender or settlement;

• *the settlement broker,* which is a firm that acts as a clearinghouse maintaining contact with 30 or 40 funders or providers; and

• *the settlement funder or provider,* who's a third party representing hedge funds, banks and institutional investors that acquire the policy either to hold or to bundle and securitize (similar to Fannie Mae's process with mortgages on a much smaller scale). Some examples of funders are Peachtree Financial Partners, Inc. in Atlanta, Coventry First in Fort Washington, Pa., and Life Settlement Solutions, Inc. of San Diego, among others.

Policies under $250,000 of death benefit, unless part of a larger portfolio, may be too small for the settlement market.

With the caveat that each transaction in this market is truly unique, the procedures and timeline resulting in a life settlement generally look like this:

Step One: An advisor, trustee, or agent (let's just say "agent" from here on) reviews an insurance policy or a group of policies. The insured may have experienced a change in health. The policy or policies could be owned individually or in trust; or it (they) could be owned by a business to fund a buy/sell agreement, a key-person or executive benefit need. For settlement to be an option for a perfectly healthy individual, that person typically must be older than 75.

Step Two: The agent collects the necessary data to review each policy. This includes policy illustrations, based on stipulated assumptions for interest or dividend[6] projecting the minimum premium (carrying cost) to continue the insurance coverage to certain ages, policy ownership and beneficiary status, policy loans and current policy values. This list of information required (plus all of the medical records and life expectancy numbers discussed below) might seem excessive. But this data does help advisors control the settlement process for the benefit of their clients.

Step Three: The agent obtains a preliminary estimate of the market value of the policy by calling life settlement brokers with a summary of the data collected for the anonymous insured.

BEST PRACTICES

Let's assume selling a life insurance policy makes sense. What's the best game plan for creating a competitive sale? Estimates of life expectancy provide a guide and should be ordered by the settlement agent to give a basis for benchmarking settlement offers. AVS of Kennesaw, Ga., EMSI in Hewitt, Texas, Fasano Associates of Washington, and 21st Services in Minneapolis are some of the companies that provide life expectancy projections for a fee of about $300 to $500.

Note that if the life expectancy is greater than 12 years, a settlement offer is unlikely.

The agent submits the authorizations, policy information and illustrations, complete medical records and cover letters to a minimum of three settlement brokers or funders. The agent also submits preliminary insurance authorizations and medical records to perhaps five insurance companies for informal underwriting to sufficiently canvas the market for competitive offers.

To select these settlement agents, settlement brokers or funders and insurance companies, an advisor should conduct a rigorous due diligence, including checking that each not only has the appropriate licenses but also a good track record. Do a background check to determine if any complaints have been registered with the state insurance boards, as well as a simple litigation search.

The agent will send very different cover letters to the settlement brokers/funders and to the insurance companies. A "glass half-empty" view of the insured's health will be stressed for the settlement brokers/funders while the "glass half-full" version will be presented to the insurance carriers who may provide preliminary insurance underwriting.

At this point in the process, it makes sense for the agent to have the insured underwritten for an immediate annuity. A rated offer (an annuity offered at a better price than standard for this individual's age, often referred to as "age rated") provides independent data on how the insurance industry views the life expectancy of this insured.

SETTLEMENT PROCEEDS VS. LIFE INSURANCE DEATH BENEFIT

Look at how long your client must live before he breaks even; then see which avenue makes sense

Example: Assume a 72 year-old client has two policies with a total death benefit of $3.1 million and a cash surrender value of $525,000. Settlement proceeds offered are $1.35 million. His projected life expectancy is eight years. He'll only break even between years 10 and 11.
Conclusion: Unless your client can earn significantly more than 6 percent on a net basis, then he should keep his policy.

Year	Age	(1) Annual Premium	(2) Death Benefit	(3) Annual Premium Accumulated at 6 per cent	(4) Death Benefit (2-3)	(5) Settlement Proceeds	(6) Difference (4-5)
1	72	$71,000	$3,100,000	$75,260	$3,024,740	$1,350,000	$1,674,740
2	73	71,000	3,100,000	155,036	2,944,964	1,261,000	1,683,964
3	74	71,000	3,100,000	239,598	2,860,402	1,336,660	1,523,742
4	75	71,000	3,100,000	329,234	2,770,766	1,416,860	1,353,907
5	76	71,000	3,100,000	424,248	2,675,752	1,501,871	1,173,881
6	77	71,000	3,100,000	524,962	2,575,038	1,591,983	983,054
7	78	71,000	3,100,000	631,720	2,468,280	1,687,502	780,777
8	79	71,000	3,100,000	744,883	2,355,117	1,788,753	566,364
9	80	71,000	3,100,000	864,836	2,235,164	1,896,078	339,086
10	81	71,000	3,100,000	991,987	2,108,013	2,009,842	98,171
11	82	71,000	3,100,000	1,126,766	1,973,234	2,130,433	-157,199
12	83	71,000	3,100,000	1,269,632	1,830,368	2,258,259	-427,891
13	84	71,000	3,100,000	1,421,070	1,678,930	2,393,754	-714,824
14	85	71,000	3,100,000	1,581,594	1,518,406	2,537,380	-1,018,974

Source: The Insurance Design Center, LLC, Deerfield, Ill.

The settlement brokers or funders use the insured's medical records to obtain at least two independent life expectancy reports, from the same pool of life expectancy companies, for comparative purposes (unless they accept the reports previously obtained by the advisor). On the basis of those reports and policy illustrations, the settlement brokers or funders will make preliminary offers to purchase the policies.

Those making the low offers must be apprised that their offers are not competitive. They'll either increase their bids or drop out during several rounds of negotiation.

This is what the industry calls "the closed bidding process." The advisor should hold his cards close to his vest to secure the best possible offers. If players are precisely unaware of what the others are bidding, they may jump way out in front.

This auction generally closes after two to four months, either when only one funder is left or the increase in competing offers becomes very small. If more than one party is left, how does one decide? Advisors should make an educated assessment of the ease of the transaction and the administrative competency of the competing parties. This determination can be made through references from other agents who've used this broker's services or from the personal experience of the agent negotiating the sale.

If replacement insurance is available, the new policy should be in force before the settlement transaction is completed. The risks of both of these transactions include a new contestable period (the two years in which the insurance company can contest payment upon the death of the insured), and the reduced insurance capacity that will be available to the client in the future, based on existing coverage still in force and owned by a third party. The new policy will require at least a month or two of premiums paid in advance even if settlement money will ultimately be used to buy the new coverage.

With a final offer in place, final calculations can be prepared to help the policy owner decide if it is more beneficial to retain the insurance coverage or to sell the policy.

When the policyholder accepts an offer, the funder prepares legal documents and transmits them to the seller.

Upon acceptance, the funder transfers the funds to an escrow account.

When the policy ownership has changed, the funds in escrow are released to the seller. Following the rescission period,[7] the funder pays compensation to the broker and agent.

The whole process normally takes 60 to 120 days, but may take longer depending on the difficulty of collecting medical information from the insured's doctors and the response time of the policyholder, insured and insurance company.

BENCHMARKS

The margin between the death benefit and the settlement proceeds is often a significant number. This must be discussed any time a life settlement is considered as a planning strategy. A basis for this discussion can be an analysis of how long it will take to reach the death benefit value at some agreed upon interest rate or rates, based on the settlement offer with annual premium funding added in and taxes taken out. A simple projection based on cash flow provides a breakeven year to compare to the projected life expectancy.

Let's consider a sample cash flow with a breakeven between years 10 and 11: Our hypothetical client is a man, age 72, with a history of quadruple bypass and cancer. His projected life expectancy is eight years. He has two life insurance policies with a total death benefit of \$3.1 million and current cash surrender value of \$525,000. The breakeven year is determined by the outlay of premium, invested for this example at a net rate of 6 percent, subtracted from total death benefit. This is compared to the settlement offer appreciated at 6 percent and adjusted for the impact of income taxes. The final outcome is a breakeven between years 10 and 11. (See "Settlement Proceeds vs. Life Insurance Death Benefit.")

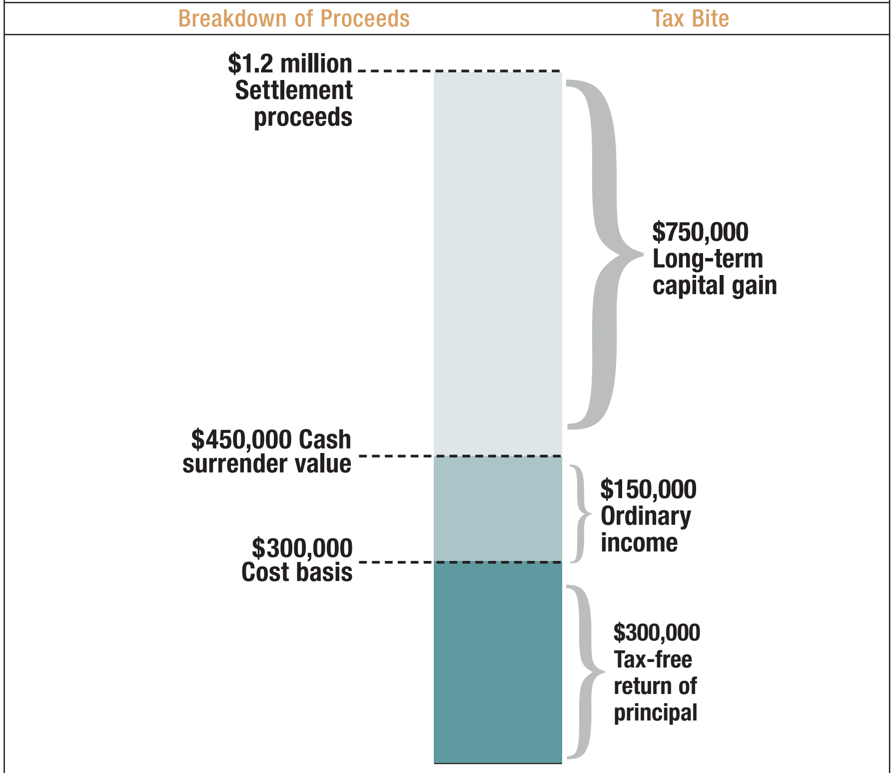
In a general analysis of settlement transactions, Peter Katt, a life insurance columnist, fee-based advisor, and principal with the Mattawan, Mich.-based Katt & Co, infers that making premium payments based on a level premium schedule overpays for insurance coverage.[8] Although difficult to administer, if one pays the annual current cost of insurance values rather than the level premium, the year in which the death benefit equals the net settlement, plus accrued interest (the crossover year), would occur later.

No advisor is a fortune teller. Some of the possible outcomes of selling life insurance contracts can be weighed by calculating the opportunity cost of premiums spent and death benefit retained versus a cash settlement net of taxes. There is the emotional issue of having a third party own insurance coverage on an insured's life. Financially speaking, the greatest downside to settling a policy is the possibility that the insured could die soon after the settlement transaction is concluded, leaving the heirs shortchanged.

HOW TO PAY TAXES ON A LIFE SETTLEMENT

Although the Internal Revenue Service hasn't weighed in on the tax implications of a life settlement, here's one approach to satisfying the taxman

Let's say your client gets a life settlement of \$1.2 million. The cumulative premiums paid (\$300,000) are his cost basis—he should recover them tax free. The cash surrender value above the premiums (\$150,000) should be treated as ordinary income. And the remainder—\$750,000—should be taxed as capital gain.



Source: The Insurance Design Center, LLC, Deerfield, Ill.

But cash in hand is not usually the primary driver for a life settlement. Often, clients want the life settlement to rebalance their assets, reclaim money held in underperforming policies, or redeploy as premium payments to augment limited gifting capacity. If, as a result of the sale, the premiums on new coverage are reduced or eliminated, some of that money can be redirected elsewhere. With additional cash available, premiums might be reduced, policy guarantees improved or coverage increased.

Generally, policies used in business planning are the most likely candidates for settlement once those business needs no longer exist. But before you settle such business-associated life insurance policies, be careful to look at the full picture: Remember, that a settled policy remains in force and could limit the insured's access to additional coverage based on financial insurability limits. Also, if the insured has serious health issues, more coverage may be difficult or impossible to acquire.

The advisors should request that both the agent and broker disclose their compensation. Such compensation may be negotiable. Typically, it ranges for a life settlement between 3 percent and 8 percent of the face amount of the policy, split between agent and broker. Compensation for life settlements is very flexible and may include bonuses paid by the broker to the agent. These bonuses are considered to be outside the settlement transaction negotiated by the agent. If additional life insurance figures into the planning process, the advisor may have more leverage with the agent to negotiate a reduced fee on the life settlement side.

TAXES

Of course, whenever a settlement is considered, advisors must look at the tax implications. Internal Revenue Code Section 101(g) provides tax exemption for viatical settlements for the terminally or chronically ill. But most settlements are not viatical. Some tax experts suggest that cumulative premiums paid constitute cost basis and should be recovered tax-free to the insured; the amount, if any, of cash surrender value in excess of the cost basis should be treated as ordinary income; and the amount of settlement proceeds in excess of the cash surrender value should be taxed as capital gain. But the Internal Revenue Service has not weighed in on these issues, and might consider all of the proceeds over basis to be taxable at ordinary income rates. It's also possible that basis might have to be reduced to account for the benefit of having the insurance coverage. (See "How to Pay Taxes on a Life Settlement.") Naturally, policyholders should consult their tax advisors and these advisors should review each transaction carefully to ensure proper tax treatment and potential tax liability.

REGULATORY ISSUES

It's also important to be aware that life settlements are not yet federally regulated. About 30 states have some form of regulation, but it's primarily limited to licensing.

Under state laws, sellers have rights of rescission for a limited period of time. Rescission is based on whether the transaction occurs in a regulated or unregulated state. For example, Florida and California are regulated and provide 15 days from the date of funding for rescission, whereas Illinois and New York are unregulated; the rescission period is based on the settlement company's procedure. Practically speaking, Coventry First, for example, provides 10 days from the date of execution of the purchase agreement as the rescission period. Generally, state consumer laws provide a rescission period of at least three days. ■

Endnotes

1. The definition of life settlements excludes those policies that would be considered "viaticated." Viaticated policies are usually policies sold on insureds with projected life expectancies of less than two years.
2. Suneet Kamath and Timothy Sledge, "Life Insurance Long View-Life Settlements Need Not Be Unsettling," *Bernstein Research Call*, Sanford C. Bernstein & Co., LLC, New York, March 4, 2005, *www.idealsettlements.com/downloads/sanford.pdf.*
3. Deloitte Consulting LLC and the University of Connecticut Actuarial Center, *The Life Settlements Market: An Actuarial Perspective on Consumer Economic Value*, May 2005, *www.lifesettlementseducation.com/.*
4. *Ibid.*
5. *Ibid.*
6. A realistic interest rate based on the current portfolio rate of return for each insurance company needs to be specified if the current illustrated rate for any company differs significantly from their portfolio rate of return.
7. For the Federal Deposit Insurance Corporation's definition of "rescission period," *see www.fdic.gov/regulations/laws/rules.*
8. "Assessing Clients' Life Settlement Offers," Peter Katt, *Journal of Financial Planning* (July 2002).

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THE INSURANCE DESIGN CENTER, LLC

500 Lake Cook Rd.
Suite 270
Deerfield, IL 60015
Tel: 847 943 0800
Fax: 847 943 0801
www.idc-llc.com