Close-Up on Life Settlements

Collateral Opportunities and the Secondary Market

by Michael Freedman and David Cherkas

The secondary market for life insurance has emerged as a substantial benefit for life insurance consumers. It is being led by life settlements, which have given life insurance policyowners more than $1 billion over the cash surrender value in their policies. The secondary market makes the primary life insurance market more valuable and meets the increasingly dynamic needs of life insurance consumers.

As expected with such success, a variety of new secondary market programs are being developed and marketed. The most recent is non-recourse premium financing that can reduce or possibly eliminate the need for collateral or personal guarantees by providing a loan that is supported by the underlying policy's future market value. These secondary market premium finance programs give advisors a powerful new tool to help meet their clients' life insurance needs.

Premium financing has long been a valuable estate planning tool. The strategy has been particularly useful in the advanced estate and business planning marketplace in which clients commonly have large insurance needs and assets they do not want to liquidate. Properly structured, premium financing with secondary market values can meet the personal, financial, and estate planning needs of qualified insureds.

It is important to be aware of several key issues when advising your clients on non-recourse premium financing programs. First and foremost, confirm that the policyowner is under no obligation or limitation to pursue any particular course at the end of the loan term. Second, well designed programs disclose the structure of the financing and the policy's true ownership. Third, if the policy is ever brought to the secondary market, the policyowner should have no obligation or requirement to offer the policy for sale through any specific broker or settlement provider. In addition, the lender should receive repayment for the outstanding loan balance with 100% of any excess going to the client.

When considering non-recourse premium financing, make sure of the following:

- The lender does not take a portion of the death benefit in addition to its right to full repayment of the loan and interest from policy inception
- The lender does not have an automatic right to purchase the policy from a consumer who is unable or unwilling to pay off or refinance the loan at maturity.
- The client is not required to forfeit the right to sell the policy for a set period and/or share any profits with the lender if the policy is sold.

These practices must be evaluated with regard to the following public policies and laws: insurable interest requirements and prohibitions against wager policies; prohibitions against usurious lending; and life settlement laws.

Insurable Interest Requirements and the Prohibition Against Wager Policies

It is well established that life insurance cannot be acquired by a person who does not have an insurable interest in the life of the insured. Generally speaking, a person has an insurable interest in his or her own life, the life of spouses and dependents, and the life of those in which there is a substantial financial interest in the continued life of the insured.

Even when there is an insurable interest, a superior public policy prohibits speculating on another person's life -- a prohibition on wagering policies. So, while a person may purchase an insurance policy on someone with whom he or she has an insurable interest, the life insurance cannot be obtained as a way to cover for a wagering policy.

Clearly, a lender has an insurable interest in the life of a borrower, but the program could be illegal if the lender stands to receive far more than the loan amount. Many jurisdictions make it illegal for lenders to receive anything in excess of the loan and related expenses from a life insurance policy.

Some state laws allow lenders to receive more than the loan amount when the lender's windfall is justified by the risk it took under the particular facts of the case. This is not the case in premium finance programs, in which the lender's investment is not in jeopardy.

Because the return of the lender's principal and interest is already fully secured, any additional right to a portion of the remainder of the death benefit (some reportedly as high as 25%) in no way

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relates to the lender's insurable interest. The lender's interest in the continued life of the insured is less than its interest in the maturity of the policy – the ultimate mark of a wager policy. If the policy is not taken out for the purpose of repaying an existing debt, rather the debt is caused by the financing of the policy itself, the program violates the prohibition against a wagering transaction.

Prohibitions Against Usurious Lending

State usury laws vary widely, with rates that indicate usury varying from 12% to 25% or higher, and any "bonus" which is due the lender in addition to the repayment of the loan can be included in the calculation of usurious rates. The California Constitution, for example, prohibits loans that carry an annual interest rate above 10%. The Constitution includes the "charging [of] any fee, bonus, commission … or other compensation" in the calculation of the rate.

Courts interpreting the usury rule have sided with lenders whose "profit is … put in hazard," but this exception has been applied to allow lenders, whose principal and interest repayments are jeopardized, to ultimately receive returns on loans that exceed the legal limit. For example, a premium finance program that provides the lender a 10% to 25% bonus of the death benefit in addition to the payment of principal and interest could violate bans on usury.

Life Settlement Requirements Relating to Premium Financing Programs

Under the National Association of Insurance Commissioners (NAIC) Settlements Model Act, which has been widely adopted, a life settlement contract "includes a contract for a loan or other financing transaction with a policyowner secured primarily by an individual or group life insurance policy." A settlement contract includes an agreement with a policyowner "to transfer ownership or change the beneficiary designation at a later date regardless of the date that compensation is paid to the [seller]."

Under the definition above, a premium finance program that locks the borrower into selling the policy back to the lenders (whether for a cash payment or for a share of the policy proceeds), would appear to be a life settlement. The same would be true if the borrower were in some way required to "buy back" the policy to maintain the coverage after the loan is repaid. Likewise, any prearranged assignment of the policy made at the inception of the loan would also constitute a settlement.

Beyond the licensing requirements, there are stringent and comprehensive transactional requirements in NAIC Model Act states that inform and protect policyowners in settlement transactions. These include two distinct sets of consumer disclosures as well as required affirmations by policyowners that they understand their life insurance policy and the settlement.

The consumer disclosures to policyowners alert them that there are alternatives to settlements; that there are tax consequences; and that settlement may affect the policyowner's eligibility for government benefits or impair their ability to obtain new life insurance. In addition, state settlement laws require policyowners be made aware of the amount of the death benefit and other benefits of the policy.

Settlement laws require escrow funding of the settlement proceeds at the time of the settlement, regardless of whether the proceeds will be paid out over time. In addition, policyowners are afforded privacy protections in settlements and have the right to rescind the settlement contract – a right that must be disclosed prior to the execution of the settlement contract.

If the premium financing includes the purchase of a life insurance policy that is deemed a settlement and these requirements are not satisfied, there can be significant consequences to the policyowner and the insured. Moreover, penalties for unlicensed settlement activity could expose the lender and the agent to enforcement by state insurance or other regulators.

Being an Informed Advisor

In doing your due diligence, make sure you are satisfied with the answers to the following questions:

- What is the lender and program sponsor information?
- Who is behind the program?
- What is the relationship between the lender and the program sponsor?
- Are the lender and program sponsor properly licensed and in compliance with applicable state insurance laws and state and federal banking laws?
- Whom will you contact throughout the term of the loan?
- Does the program sponsor represent other programs and have experience within the life insurance market?
- What are the program specifics?
- What is the loan rate?
- Is the loan rate fixed or simple interest?
- Is the client receiving cash or any other consideration up front?
- Beyond indebtedness, does the client have any additional costs or fees?
- Other than the policyowner, does any party have an interest in the policy at the time of issue (other than the lender's security interest for the loan)?
- Are there requirements for the policy to be assigned at the initiation of the loan or any time during the term of the loan?
- Does the client have to sell or otherwise assign the policy or can he/she keep it unencumbered after the loan is paid off?
- Does the client keep the whole face amount if he/she pays off the loan and keeps the policy?
- If the client decides to sell or otherwise assign the policy, is he/she obligated to go to certain brokers/providers?
- If the client sells or otherwise assigns the policy, does he/she get to keep 100% of the proceeds?

Conclusion

Premium financing that is supported by a life insurance policy's underlying future market value is just one of the recent offspring of the secondary market for life insurance. Well designed and properly administered, these programs are providing advisors with a powerful new tool and clients with a new way of meeting their estate planning needs. ❑

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