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Life Settlements: Tax, Accounting, and Securities Law Issues

As this second part of a two-part article explains, life settlements create a new dimension in planning for seniors that requires life insurance to be actively managed no differently from fixed income, equity, and real estate assets.

Stephan R. Leimberg, E. Randolph Whitelaw, Richard M. Weber, and Liz Colosimo

In the last issue of Estate Planning, the first part of this two-part article[1] explored the elements of life settlements, the operation of the secondary life insurance market, and the duty of estate planning advisors to consider life settlements for their clients. This second part of the article examines the tax, accounting, and regulatory aspects of life settlements, as well as other issues professionals must consider with respect to life settlements.

Tax implications

Leimberg: ***What are the tax implications of a life settlement?***

Weber: There are no Internal Revenue Code provisions or published cases or even private letter rulings pertaining specifically to the income taxation of life settlements. A detailed discussion of tax implications is beyond the scope of this article, but many authorities use the following assumptions in calculating the projected tax liability:

- If the cost basis of the seller's policy (the total amount of net premiums paid) is higher than the life settlement amount, the seller will not realize any taxable income from the transaction.
- If the life settlement amount is higher than the seller's cost basis, the excess is taxable. The excess of the policy's cash surrender value at the sale date over the seller's basis is treated as ordinary income and is taxed at the seller's marginal tax rate. Some authorities take the position that the excess of the life settlement amount over the policy's cash surrender value is a capital gain[2].
- If the policy has no cash surrender value, or the surrender value is less than the policy's cost basis at the date of policy sale to the provider, then consistent with the above "assumptions", the excess of the settlement amount over the seller's cost basis would be treated as a capital gain.

This projected tax liability should be calculated by the seller's tax advisor as part of the initial "trade-off" evaluation of life insurance versus a life settlement, and certainly taken into account before a life settlement offer is accepted. Moreover, the tax consequences to the policy owner/seller of receiving a cash payment during the insured's lifetime are not as favorable (or certain) as that of receiving the policy's death benefit.

Advisor's assistance needed

Leimberg: ***What are the 'red flags' signaling that a professional advisor***

STEPHAN R. LEIMBERG is an attorney and is CEO of Leimberg and LeClair, Inc., an estate and financial planning software company; President of Leimberg Associates, Inc., a publishing, software, and marketing consulting company in Bryn Mawr, Pennsylvania; and Publisher of Leimberg Information Services, Inc., which provides email-based news, opinion, and information for tax professionals. He is also a former adjunct professor in the Masters of Taxation Program of both Temple University School of Law and Villanova University School of Law. He is a nationally known speaker on taxation and estate planning, and co-author, with Howard Zaritsky, of Tax Planning with Life Insurance. His email is Steve@leimbergservices.com.

LIZ COLOSIMO is Co-Managing Director, with Randy Whitelaw, of Life Settlement Partners, LLC. She focuses on placement of large death benefit policies. She is a licensed life settlement broker, registered nurse, and attorney. Her email is LizColosimo@lifesettlementpartners.com.

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E. RANDOLPH WHITELAW is Co-Managing Director of Life Settlement Partners, LLC, in St. Louis, which provides life settlement consulting and brokerage services to individuals, businesses, charities, advisors, and fiduciaries. He manages the firm's consulting engagements. He is also Managing Director of Trust Asset Consultants, LLC, which provides TOLI (trust-owned life insurance) fiduciary risk management consulting services. He is a recognized TOLI placement, management, and restructuring expert. His email is RWhitelaw@lifesettlementpartners.com

RICHARD M. WEBER, MBA, CLU, is President of The Ethical Edge, Inc., in Carlsbad California. His firm provides training and consulting services that help empower life insurance agents, advisors, and their clients to explore and view life insurance in the broader context of financial planning. With several books and more than 200 published articles, Mr. Webber addresses topics as diverse as insurance product due diligence and the appropriate use of technology. His email is Dick@EthicalEdge.biz.

should assist his/her client with respect to life settlements?

Colosimo/Weber/Whitelaw: A professional advisor's intervention must be provided in the following situations:

- When captive life insurance agents or registered representatives are "restricted"[3] from discussing life settlements with their clients.
- When corporate trustees of an irrevocable life insurance trust ("ILIT") claim a limited duty arrangement with "hold harmless" protection, or disclaim responsibility for insurance policy selection.[4]
- When policy exchange or "replacement"[5] is recommended because an in-force policy is no longer affordable and/or is significantly under-performing its originally illustrated policy values.
- Whenever policy replacement is recommended based on an agent-coordinated "Life Insurance Audit"[6]. Such "audit" usually compares in-force policy values to a sales illustration projecting policy values that appear to justify replacement of the existing policy. Life insurance agents, life insurance companies, and brokerage general agents know that illustrations are neither credible nor appropriate for such policy comparison purposes.

Professionals must recognize the failing policy crisis represented by indeterminate premium policies purchased more than five to ten years ago, unless scheduled premiums have been adjusted based on a credible evaluation of premium adequacy. This crisis adversely affects seniors, especially seniors underwritten with an "impaired risk" rating classification. Due to declining interest rates over the past 20 years and "bear" market conditions between 2000 and 2002, most universal life, adjustable life, and variable universal life policies are significantly under-performing their originally illustrated policy values. Premium adjustment is needed to avoid policy lapse sooner than originally illustrated and possibly before the insured's life expectancy.

Concerns regarding "illustration credibility" were addressed by the life insurance industry in the early 1990s. Professionals should know that carrier illustrations for indeterminate premium policies depict how a policy works, but they disclaim predictive value, do not evaluate premium adequacy, do not assess the reasonableness of agent- and carrier-controlled assumptions, and are not appropriate for policy comparisons[7]. Further, it is difficult to imagine any professional relying on a linear (constant rate) projection over a 25- to 50-year time horizon that does not consider market volatility. The failing policy crisis of the last 15 years demonstrates that such illustrations are meaningless for the purposes of professionals who are advising their clients. Particularly at risk are seniors receiving lapse notices and/or replacement presentations without adequate disclosures. Actuarial evaluation must be used for credible (independent) premium adequacy calculations and defensible policy comparisons when policy exchange, replacement, or sale is under consideration. While indeterminate flexible premium policies have become the product of choice for sophisticated life insurance planning, these products- require credible evaluation of premium adequacy and active policy value management. A professional advisor should expand his/her "senior" practice management process to identify situations appropriate for life settlement. Thereafter, the advisor plays a key role in obtaining a credible and appropriate life insurance analysis, collaborating with a life settlement consultant, and helping the policy owner understand the policy restructure options and the life settlement transaction process.

Leimberg: ***How has the life insurance community reacted to the increase in life settlements?***

Weber/Whitelaw: "Life insurance companies are concerned that policyholders may not receive complete information from properly trained agents on the suitability of a life settlement transaction."[8] In fact, some life insurance groups suggest that life settlements may adversely impact carrier profits which, in turn, may adversely affect existing shareholders. These carriers may view life settlements as a potential threat for two basic reasons: First, " the vast majority of life insurance policies either lapse before the end of their term or are surrendered

[1] See Leimberg, Whitelaw, Weber, and Colosimo, "Life Settlements: Risk Management Guidance for Advisors and Fiduciaries," 33 ETPL 3 (Aug. 2006).

[2] Ratner, "Cash Out or Cash In?," 144 Tr. & Est. (May 2005): "The tax treatment of a life settlement is unsettled. One point of view is that the settlement proceeds up to basis are received tax-free, the excess of the proceeds up to the remaining amount of cash value are ordinary and any excess of proceeds over the cash value is capital gain. But, there is no official guidance on the matter, and the Internal Revenue Service might consider all the settlement proceeds in excess of the basis as ordinary income."

[3] Dougherty and Singer, *The Benefits of a Secondary Market for Life Insurance Policies* (Wharton School, University of Pennsylvania, October 2002); http://fic.wharton.upenn.edu/fic/papers/02/0241.pdf: "These prohibitions by incumbent life insurance carriers are anticompetitive: they seek to erect a barrier to entry against viatical and life settlement firms for all policies that the incumbents could potentially repurchase. In addition, by forcing agents to restrict their client advice to an incomplete array of options (even when the agent knows that a viatical of life settlement might best meet the client's needs), these prohibitions risk undermining the credibility of carriers' life insurance agents and exposing them to legal liability. Finally, these prohibitions are over-reaching in scope: restrictions on the ability of agents or brokers to assist clients in the sale of life insurance policies issued by other carriers strongly suggests industry-wide boycott of viatical and life settlement firms."

[4] When a life insurance policy is owned by an irrevocable trust, generally all "incidents of ownership" are conferred on the trustee so that policy proceeds are not includible in the decedent's estate. As such, the trustee is the only party with the duty and authority to make insurance policy decisions. If a corporate trustee seeks protection per a limited duty arrangement or hold harmless language or disclaimer language relative to policy selection (product suitability) and policy value monitoring, (1) who is responsible for policy decisions? (2) does a limited duty arrangement document that the trustee is acting as the agent of the grantor/insured? and (3) if so, are policy proceeds includible in the decedent's estate?

[5] Ratner, "Life Insurance Policy Replacements: Real Peanuts Or Just A Shell Game?," 139 Tr. & Est. 12 (April 2000): "Replacement of life insurance policies, though commonplace, is fraught with potential problems – and opportunities – for estate planners…We start with the presumption that an existing policy should be preserved. Said another way, the proposed replacement bears the burden of showing that it can legitimately meet the policyowner's needs more effectively or more efficiently than the existing policy."

before benefits are paid…which provides a windfall to the insurer."[9] This expectation is built into current product pricing. Because life settlement funders maintain a policy until the insured's death, carriers assume their profits will fall and premiums (and cost of insurance and expenses) must rise to offset the losses. This may be so, at least temporarily, until the insurance industry reestablishes pricing equilibrium.

The second perceived threat is that life settlement may reduce the funds available for the life insurance asset class. However, current statistics reveal that approximately 85% of proceeds from life insurance policy sales are placed in new financial products such as life insurance, annuities, and long-term care insurance.

Some life insurance carriers prohibit their agents from discussing or transacting life settlements. Such restrictions pose "twisting" and "misleading representation" concerns. Many states now require all insurance companies to inform their policyholders of the availability of life settlements under certain circumstances, such as:

- When a life insurance company receives a request to surrender, in whole or in part, a life insurance policy or a certificate under a group life insurance policy.
- When a life insurance company receives a request for an accelerated death benefit under a life insurance policy or a certificate under a group policy.
- When a life insurance company receives a request to assign a life insurance policy or a certificate under a group life insurance policy as security for a loan.
- When a life insurance company sends a notice of lapse of a life insurance policy or a certificate under a group life insurance policy.

A few carriers restrict transfer of their policies, and some states permit insurers to write policies that cannot be sold in the secondary market. Such restrictions effectively separate policy owners from the rights inherent in the ownership of personal property. A 2002 study, also known as the Wharton Study[10], addresses this transfer issue: "Life settlement increases the value consumers attribute to insurance policies, meaning that consumers benefit more from, and therefore are more willing to pay for, life insurance policies that can be sold in life settlement than from policies that are not assignable."

With the knowledge that these restrictions exist, it is incumbent upon professionals to (1) inform their clients about life settlements, (2) identify life insurance planning situations appropriate for this option, and (3) assist in determining if a policy qualifies for life settlement.

Accounting aspects

Leimberg: ***Discuss the accounting aspects of life settlements.***

Weber/Whitelaw: A significant milestone for the life settlement industry in 2005 was the clarification of acceptable accounting treatment for life settlement transactions by the Financial Accounting Standards Board ("FASB")[11]. A new "investment method" was tentatively adopted and represents a significant change from the former "cash surrender value" approach. This clarification is expected to attract additional institutional purchasers, such as trusts and pension funds.

The investment method capitalizes the initial investment (purchase price) and continuing costs (policy premiums and direct external costs, if any). "In effect, each year's premium cost is to be deb-

[6] O'Shaughnessy, "Funny Business," Wealth Manager Magazine (Dec. 2005/Jan. 2006): "Insurance experts who don't sell products insist that too many professionals who have a direct or indirect relationship with insurers are too hasty in recommending replacement of old policies in trust. "Most policy replacements, according to both insurance industry regulators and independent academic research, will not be in the best interest of the policy owner," warns Patrick Collins, partner at Schultz Collins Lawson Chambers Inc., an independent investment counsel firm in San Francisco and Baltimore that offers insurance advisory services. When expert trustees recommend or facilitate a policy replacement, Collins says, they could face a "heavy burden of proof" that they're following a prudent decision-making process. What especially aggravates Collins are insurance marketing campaigns aimed at potential trust customers that, he alleges, skew the intent of the Uniform Prudent Investor Act. As they would with other trusts, fiduciaries of insurance trusts are supposed to monitor and review the assets in the trust to make sure they remain prudent and suitable. Collins has seen sales pitches, however, that suggest that a trustee must ditch a policy if it doesn't represent today's best deal in a market that obviously continues to evolve. "Many policy replacement campaigns envision the trustee hopping from carrier to carrier in an attempt to maximize return," which, he adds, only encourages trustees to "treasure hunt". If you extended that curious interpretation of the UPIA to investment trusts, he says, it would require that a trustee somehow buy the best performing stocks in rising markets and then liquidate it all into Treasury bills in collapsing markets."

[7] Whitelaw and Weber, "Trust-Owned Life Insurance: Risk Management for Fiduciaries," 32 ETPL 14 (Sept. 2005): Credible premium adequacy and policy performance analysis is essential in the senior market and requires actuarial evaluation, not illustration-based comparisons. The practice of using illustrations to compare an inforce policy to a new policy, often described as a "Life Insurance Audit", is akin to comparing an apple to a monkey wrench. Sales and inforce illustrations for indeterminate premium policies (universal life adjustable life, and variable-universal life) disclaim predictive value and, hence, are neither credible for premium adequacy calculation purposes nor appropriate for policy comparison purposes. "In 1992, the Society of Financial Service Professionals introduced the Illustration Questionnaire ("IQ") and clarified, "…illustrations have little value in predicting actual performance or in comparing products and companies…So the risks associated with the possible inability of a product to achieve the higher illustrated benefits, or lower illustrated costs, than those generated by the guarantees are borne by the policyholders." Also in 1992, the Society of Actuaries published an extensive examination of illustrations and illustration practices associated with the purchase of life insurance, and concluded that there are two major uses of illustrations: Type A usage is intended to show the consumer the mechanics of the policy being purchased and how the policy values or premium payments change over time. The emphasis is a matter of how and what rather than how much. Type B usage tries to project likely or best estimates of future performance and compare the cost or performance of different policies. It attempts to show how much on the premise that the hows and whats are comparable enough to be meaningful. The report of the Society of Actuaries went on to explain, Most illustration problems arise because illustrations create the illusion that the insurance company knows what will happen in the future, and that knowledge has been used to create the illustration…To summarize, the Task Force endorses the use of illustrations for Type A purposes. We do not believe they are appropriate for Type B purposes." Ben G. Baldwin comments in his book, *The New Life Insurance Investment Advisor*, predictive illustration-based methods are doomed to failure because the numbers used in illustrations are filled with assumptions that are not comparable company to company and that are more and more flawed, and less and less reliable, as they project further into the future".

[8] Deloitte Consulting LLP and The University of Connecticut, *The Life Settlements Market – An Actuarial Perspective on Consumer Economic Value* (May 2005): www.lifesettlementseducation.com/pdf/Life_Settlements_Mrkt_3.pdf.

[9] *The Benefits of a Secondary Market for Life Insurance Policies*, *supra* note 3.

ited entirely to an asset account and there appears to be no charge to earnings while the asset (the life insurance policy) is held by the life settlement acquirer. When death occurs and policy benefits are paid, the excess of those benefits over the amount carrier in the asset account is credited to income. Finally, during the life of the insured 'when the carrying amount of the life settlement contract equals the underlying insurance policy's face value, all future premiums and direct external costs shall be expensed.' Although we cannot pose as experts in carrying on (for accounting for) life settlement activities, it would appear that this new approach would provide a greater opportunity for life settlement companies to avoid an expense burden in the earliest years after policy acquisition."[12]

Prior to this clarification, life settlement investors were required to value purchased policies at their cash surrender value. The difference between the fair market value ("FMV") purchase price and cash surrender value at the time of purchase was reported as a loss by the purchaser. If the increase in cash surrender value in subsequent years was less than the premium payment, the difference generated a loss and vice versa.

Regulation issues

Leimberg: *Discuss life settlement regulation issues.*

Weber/Whitelaw: As of February 2006, 27 states had adopted life settlement legislation. Such legislation is pending in another 12 states. Because insurance is state regulated, licensing requirements for brokers and providers vary by state. Some states require a separate life settlement broker license, others require only a life insurance license, while a few require no licensing at all. In June 2004, the National Association of Insurance Commissioners ("NAIC") adopted a model regulation that does not require separate licenses for agents who recommend settlements. NAIC model regulations are not law but rather serve as recommendations for each state. In July 2004, the National Association of Insurance Legislators (NCOIL) also supported efforts not to require separate licenses.

State regulation plays a key role in addressing concerns about full disclosure (often referred to as "transparency"), discussed later in this article. From a consumer protection perspective, these regulation and licensing changes create more awareness of the settlement options available to life insurance policy owners, and more consistency in representing both the economic interests of the policy owner and the privacy issues of the insured. Before participating in a life settlement transaction, professionals should confirm that the broker and the provider are state licensed.

Leimberg: *Discuss life settlement securitization.*

Whitelaw: Life settlement securitization is generally viewed as an emerging capital markets transaction. The first such securitization occurred in 2004, with a private placement for $70 million in bonds backed by life insurance policies and rated by Moody's Investor Services. Subsequently, A. M. Best published[13] its methodology for rating life settlement-backed securities. One of A.M. Best's rating conditions is that all life settlements in the portfolio must have been purchased at least five years before the date of its evaluation of the transaction. Structured properly, investments in life settlements provide substantial returns by comparison to more traditional investment alternatives. Hence, portfolio securitization is expected to increase significantly as portfolios reach this five-year benchmark.

Leimberg: *Is the sale of a life insurance policy a securities transaction?*

Whitelaw: A life insurance policy is personal property and a policy owner has the right[14] to sell the contract. In September 2002, the North American Securities Administrators Association ("NASAA") unanimously adopted *Guidelines Regarding Viatical Investments* which contain an express exemption from securities registration and qualification for "viatical" or "life settlement" transactions.[15] "The prevailing view of the courts and regulators is that front-end settlement transactions are not 'securities' within the meaning of the federal or state securities laws…By contrast, several states have included the investment, or back-end, transaction within the scope of their blue-sky laws, providing a layer of investor protections that insure against potential abuses. Many states also have adopted insurance rules comprehensively regulating life settlements and settlement providers, providing additional regulatory protection for policyholders. In light of these state-law developments, therefore, there is no justification for insurers to impose generic rules restricting or prohibiting agents or brokers from participating in life settlements."[16]

Concerning the back-end, the exemption under the securities laws generally applies to policies purchase by an institutional funder and held in trust. However, if a policy or fractional interest thereof is sold by a provider to individual investors, this transaction is generally deemed a securities transaction and must be registered as such under applicable securities laws and regulations. This securities question should be reviewed on a case-by-case basis at the time policy sale is being considered.

Leimberg: Discuss any special broker-dealer issues.

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[10] Id.

[11] FASB Technical Bulletin 85-4, Accounting for Purchases of Life Insurance. FASB Technical Bulletin 85-4-1 allows purchasers of life insurance policies to select between using the investment method or the fair value method to value the policies on an "instrument by instrument" basis. However, once a decision is made, it is irrevocable. Purchasers that use the investment method can "recognize the initial investment at the transaction price plus all initial direct external costs." But the investor cannot recognize a gain until the death of the insured. Then, the investor can recognize in earnings the difference between the carrying amount of the life settlement contract and the life insurance proceeds paid on the underlying life insurance policy. Purchasers using the fair market value method can recognize the initial investment at the transaction price and later at each accounting period recognize estimated changes in the fair value. An investor must report assets recorded using the fair value method separately from the assets recorded using the investment method and report the number of life settlement contracts held using each valuation method, the carrying value of those contracts, and the face value of the life insurance policies behind the life settlement contracts.

Whitelaw: Product suitability has become an increasingly sensitive broker-dealer compliance issue when registered representatives consider life insurance recommendations for clients age 60 and older. Because life settlements are appropriate for individuals age 65 and older, their suitability must be considered. "In the securities industry, suitability is mandated by NASD Conduct Rule 2310. The rule has been interpreted to apply the suitability requirement to situations where a customer is advised to do nothing – for instance, to retain an existing insurance policy rather than accept a life settlement. Moreover, NASD suitability rules prohibit broker-dealers from creating incentives for their registered representatives that favor their own proprietary products (such as continued premium payments on, or cash surrenders of, existing policies from the insurance company parent of a broker-dealer over competing non-proprietary products such as life settlements). Securities regulators place a high priority on ensuring that registered representatives are indifferent as between a client's selection of proprietary or non-proprietary products. Similar suitability principles have been adopted in the insurance industry by the Insurance Marketplace Standards Association. These suitability rules clearly would seem to apply to a recommendation to surrender a policy when a more advantageous life settlement is available."[17]
In early 2006, the National Association of Securities Dealers ("NASD") announced it is preparing a notice for members about participation in life settlement transactions. "We realize that the ability to sell these assets [life insurance policies] can be of vital importance to their owners and that in many, if not all cases, the price of the secondary market transaction exceeds the redemption price that would be paid by the contract's issuer. But we believe there are other considerations worth noting, such as alternative sources for income or alternative premium payment sources that might be considered before recommending such a sale." The NASD is hoping its life settlement notice "will offer balanced guidance on how to participate in such transactions from a member perspective."[18]

Variable policies

Leimberg: ***Discuss any special considerations unique to the purchase of a variable policy.***

Weber: As a practical matter, every life settlement application involving a variable policy requires special handling. Providers generally are interested in purchasing the policy's insurance or death benefit component, not the investment component. A few providers are experienced in separating the two components and will consider a variable policy. Most providers avoid variable policies because of their related uncertainties: for example, does a life settlement broker also need to be NASD licensed? Should compensation be paid to the life settlement broker or to a broker dealer?

Professional concerns

Leimberg: What ***are some of the issues and concerns a professional must consider with respect to life settlements?***

Weber/Whitelaw: The client must truly understand the rights – and obligations – forfeited in exchange for a lump-sum purchase of the policy. Product suitability and full disclosure are market conduct concerns at the financial services, life insurance, and life settlement industry levels. Well-publicized investigations and lawsuit settlements demonstrate the need for third-party intervention to address transparency issues at all levels. It is imperative that the policy seller has the guidance of a trusted professional advisor who will engage, if appropriate, an independent consultant to assist a credible and fully disclosed transaction process.

Focusing on transparency in the life settlement industry, the 2006 Conning Study[19] comments: "A lack of transparency on the transaction is an inhibitor of growth of life settlements. Three separate forces are working to address transparency. Several states have mandated disclosures at the time of settlement. While there is current concern that many of the rules are too broad, and their enforcement too spotty, to be truly effective, their presence represents a step toward a much more fully disclosed marketplace. Also, an increasing number of settlements are being negotiated with more than one broker, increasing the likelihood that the insured is presented with a more competitive offer. Several online auction sites have sprung up to assist in this effort. Finally, some institutional investors are forcing increased transparency on the market. Unwilling to expose themselves to negative publicity that might result from a transaction deemed abusive, they mandate the commission and expense levels on the cases where they participate and disclosure of these amounts to the seller."

Professionals and their clients should be aware of New York Attorney General Eliot Spitzer's continued investigation of insurance industry practices, including life settlements. Recently, insurance broker National Financial Partners (NFP: NYSE) disclosed it had received a subpoena from Spitzer's office seeking "information regarding life settlement transactions". NFP's 10-K report also disclosed that one of its subsidiaries (Advanced Settlements, Inc.) received a subpoena seeking the same information.[20] This investigation follows an earlier investigation of AIG, which resulted in a $1.64 billion settlement.[21]

In May 2004, the Florida Office of Insurance Regulation[22] and the U.S. Securities and Exchange Commission ("SEC") shut down Mutual Benefits Corporation for violations of Florida and federal laws involving securities violations, fraud and misrepresentation. Mutual Benefits was considered the nation's largest "viatical" settlement company and sold policies as viatical investments. Viatical investors experi-

[12] AALU announcement.
[13] *Life Settlement Securitization*, A.M. Best Company, Inc. (10/18/04).
[14] Grigsby v. Russell, 222 U.S. 149 (S.Ct., 1911).

enced significant losses. [23]

Ongoing investigations highlight unacceptable and inappropriate marketing, life expectancy calculation, and broker compensation practices, and reinforce the importance of engaging a life settlement consultant to safeguard against the transparency concerns cited in the 2006 Conning Report.

In 2005, several significant developments addressed this transparency issue:

- Bernstein Research Call published a study that predicted the secondary market growth opportunity but conditioned its prediction on responsible practices and warned that questionable sales practices could lead to increased litigation.
- Deloitte Consulting and The University of Connecticut published a study[24] comparing the economics of selling a policy in the secondary market versus holding it until death. The study concluded that "The policyholder with impaired health could maximize estate value if other assets are liquidated and the life insurance policy is maintained until death. 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. The beneficiary, who has a vested benefit in maintaining the life insurance contract, can help preserve a high-yielding , tax-free asset by securing funds to satisfy the liquidity needs of the policyholder or by assuming the premium payments on the life insurance policy. The return on the beneficiary's investments to preserve the life insurance contract is likely to exceed any other investment option." (See below for further discussion.)

While the findings indicated that the life insurance vs. life settlement controversy is likely to persist, the study also reinforced the importance of professional responsibility and ethical business practices. Specifically, the study findings call for conduct that demonstrates an understanding of client's current objectives, credible evaluation of planning options, and informed recommendations as to product suitability.

- Five more states passed life settlement legislative bills.[25] This demonstrates the recognition and acceptance at the state level of the growing life settlement market.
- FASB clarified its accounting treatment for life settlement transactions, as discussed earlier.

Questionable practices

Leimberg: ***Can you be more specific in describing questionable practices? For example, noted life insurance author Ben Baldwin recently questioned "free life insurance[26]" and expressed concern over "stranger-owned" life insurance.***

Weber/Whitelaw: Professionals should not confuse traditional life insurance planning and the use of contemporary life insurance management tools, such as life settlement, with schemes involving questionable marketing practices, such as Stranger-Owned Life Insurance ("SOLI")[27] and Investor-Owned Life Insurance ("IOLI"). Engaging of a life settlement consultant overcomes the restrictions placed on agents and registered representatives, and can avoid exposure to the following questionable practices:

- *Insurable Interest.* Insurable interest is not a concern for a true life settlement transaction. While an insurable interest does *not* exist between the parties, "… well-established legal precedent confirms the right of the policy owner (presuming that party had insurable interest under state law when he/she purchased the policy) to sell the contract."[28]

As noted by Baldwin, insurable interest has become a major topic of concern because of marketing programs that involve the purchase of *new* life insurance policies with the *expectation* they will either be sold as life settlements or maintained in-force until the death claim is paid. The insurable interest concern focuses on the questionable relationship between the parties at the *outset* of these programs, and gives rise to descriptions such as "free insurance" and "rent-a-body" programs (so-called SOLI plans) that also may be a violation of state anti-rebating laws. Promoters of such plans offer large financial incentives for an individual to purchase a policy on his/her life with an expectation of (1) no-cost coverage for two years due to a so-called non-recourse loan and (2) the potential at the end of two years to share in the proceeds from sale of the policy to a life settlement company. These promoters may participate in investment gains as well as serve as agent or broker for insurance and annuity products, earning significant commission and expense allowance compensation. And, if a policy is subsequently sold as a life set-

[15] North American Securities Administrators Association ("NASAA"), *Guidelines Regarding Viatical Investments* (Sept. 2002. "Viatical Investment means the contractual right to receive any portion of the death benefit or ownership of a life insurance policy or certificate, for consideration that is less than the expected death benefit of the life insurance policy or certificate. Viatical Investment does not include: (a) any transaction between a viator and a viatical settlement provider as defined by [reference to state statute or most recent version of the NAIC Model Viatical Settlement Act]; (b) any transfer of ownership and/or beneficial interest in a life insurance policy from a viatical settlement provider to another viatical settlement provider as defined by [reference to state statute or most recent version of the NAIC Model Viatical Settlement Act] or to any legal entity formed solely for the purpose of holding ownership and/or beneficial interest in a life insurance policy or policies; …[Drafting Note – The definition of Viatical Investment is intended to include transactions in life insurance policies regardless of the age or health of the insured. Some states may have adopted insurance laws that modify the NAIC Model Viatical Settlement Act to limit the scope of coverage to insureds who are terminally or chronically ill. States are encouraged to review their respective insurance laws for consistency.]"

[16] Brooks and Baird, "Clients May Hold Millions in Untapped Insurance Wealth, Study Finds", On Wall Street (Nov. 2002).

[17] *Id.*

[18] "NASD Vice Chairman Eyes Secondary Life Market (Corrected)", National Underwriter Online News Service (3/22/06). These comments were made by NASD Vice Chairman Mary Shapiro at a conference organized by the compliance and legal division of the Securities Industry Association.

tlement, the promoters may serve as broker and earn another sizeable fee.

Professionals should differentiate traditional premium financing options from the promoter schemes discussed above.[29] That said, premium financing, like life settlement, is an important option for life insurance planning and policy management that should not be overlooked by seniors.

- *Broker Compensation.* Compensation for a life settlement broker can be significant and varies by provider. The 2006 Conning Report[30] "suggests that a typical current standard would allocate the lesser of 6% of the face amount of the policy or one-third of the increased value provided to the policy owner (increased value equals the excess of the settlement offer to the policyholder over the cash surrender value of the contract)." Offers can be communicated to the policy owner on either a gross or net (of broker compensation) basis. A net offer may provide for broker compensation far in excess of this current standard. A professional should clarify the compensation arrangement before the broker is selected, and should obtain written confirmation of the gross offer and earned fees before reviewing an offer with the policy seller.

Life settlement transactions can provide life settlement brokers with multiple opportunities for compensation. For example, the broker will earn a fee on the life settlement transaction, may continue to earn a commission as the agent of record on the in-force sold policy, and may earn a commission from the sale of a new policy. The commission arrangement should demonstrate reasonableness and appropriateness in the context of the total transaction.

Additional issues

Leimberg: ***Can you expand on the issues addressed in the Deloitte Consulting and The University of Connecticut Study?***

Weber/Whitelaw: The Study, titled *The Life Settlement Market – An Actuarial Perspective on Consumer Economic Value*[31], was financed by three major life insurance carriers and undertaken to quantify the value of maintaining a life insurance policy and to discuss concerns about full disclosure. This Study questions the analysis and some conclusions of the Wharton Study titled *The Benefits of a Secondary Market for Life Insurance Policies*.[32] The Deloitte/U.Conn Study makes several key points:

- Policy owners incur a lost economic value when a policy is sold;
- Policy owners should consider the liquidation of other assets to pay premiums if life insurance protection is still needed;
- Life settlement agents should have specialized training to provide proper financial advice to policyholders;
- Policy owners should receive complete information from properly trained agents on suitability; and
- "The life insurance industry is well-positioned to create a more efficient secondary market for impaired policyholders similar to accelerated death benefits for viaticals or a loan to the policy holder using the face amount of the policy as collateral."

Further, in a section titled "Perceived Benefits of Life Settlements Revisited", the Deloitte/U.Conn Study responds[33] directly to four major points made in the 2002 Wharton Study about the benefits of a secondary market:

1. <u>Wharton</u>: "It [Life Settlements] introduces an organized secondary market for life insurance that otherwise would have been available only informally or from life insurance companies through the surrender of a life insurance policy." <u>Deloitte/U. Conn</u>*:* "This perception is correct and is one of the most valuable contributions made by the Life Settlements industry. This secondary market is more efficient than the existing surrender option available in the policy. However, the expect IEV (intrinsic economic value) of retaining the life insurance contract always exceeds the Life Settlements value."

2. <u>Wharton</u>: "It provides liquidity to a life insurance contract which is a relatively illiquid asset by itself. This could increase the value of a life insurance contract in the primary market as well." <u>Deloitte/U. Conn</u>*:* "The Life Settlements transaction does not provide liquidity. The notion that the sale could increase the value of the life insurance contract in the primary market needs to be qualified further. We have demonstrated that only policyholders with no estate needs or those who have estate and liquidity needs with no other sources of liquidity would benefit from a Life Settlements sale. Otherwise, retaining a policy until death is a higher yielding investment decision for a policyholder with impaired mortality. Even when a policyholder with

[19] Conning Research & Consulting, Inc., *Life Settlement - The Concept Catches On* (2006).

[20] Research Department of Fox-Pitt, Kelton Inc. (3/9/06).

[21] Goldstein, "Insurance Probe Defies Death", The Street.com (3/9/06). "This is not the first time that Spitzer has gone after the life settlement industry. A portion of the $1.64 billion settlement Spitzer's office reached earlier this year with AIG covered allegations the New York Prosecutor had raised about improprieties in the big insurer's life settlements business. In a civil complaint filed against AIG last year, Spitzer alleged that the insurer tried to conceal that it was buying life settlement policies from a Philadelphia-based firm called Coventry First. Spitzer charged AIG set up a special trust called the Coventry Life Settlement Trust both to hide that it was buying these unused insurance policies, and to avoid an accounting rule that requires the policies to be initially booked as a loss. The complaint said buying and collecting life settlements was a $1 billion business for AIG. Spitzer's office did not allege any wrongdoing on the part of Coventry First, which was founded in 1999 and is the nation's biggest buyer of life settlements. TheStreet.com reported in 2004 that AIG was one of the main financial backers of Coventry First."

[22] "Federal, State Regulators Shut Down Nation's Largest Viatical Settlement Company", Department of Financial Services, Office of Insurance Regulation, State of Florida (5/5/04).

estate needs has no other sources of liquidity, other alternatives should be considered to preserve his/her life insurance contract. These alternatives could include borrowing the required funds or taking a policy loan to meet current liquidity needs and pay future premiums, or getting the beneficiary or trustee to loan some of the proceeds and assume premium payments. While it is difficult to estimate the subset of the Life Settlements market (i.e. greater than 65, impaired mortality, large face amount policies) that has no estate needs, it is reasonable to assume that it constitutes only a fraction of the potential $100 billion market estimated by studies on the Life Settlements industry. It is unclear whether such a small subset of the Life Settlements market that will benefit from Life Settlements sale would have any impact on the value of a life insurance contract in the primary market."

3. Wharton: "The resale values offered in the secondary market for life insurance policies of people with impaired health are significantly higher than the cash surrender values of the policies."
   Deloitte/U Conn: "We have demonstrated in the Actuarial Valuation section of this paper that the LSV (lost settlement value) is always greater than the CSV (cash surrender value). However, the IEV always exceeds the LSV as well. For a proper evaluation on the merits of selling a life insurance policy in the secondary market, the IEV of retaining the contract and the LEV (lost economic value) caused by selling the policy to a Life Settlements company should be clearly disclosed to have a balanced picture of all the options available to a policyholder with impaired health."

4. Wharton: "The existence of an efficient secondary market in the financial services industry could improve the economic welfare of consumers in general, as well as the value of the corresponding asset in the primary market."
   Deloitte/U Conn: "This statement is true only for policyholders with impaired mortality who have no estate needs. For senior citizens with estate needs and other sources of liquidity, selling a life insurance contract in the current secondary market could mean sacrificing the most lucrative asset owned by the policyholder for only a fraction of its IEV. The impact on the value of a life insurance contract in the primary market has been discussed in point (2) above."

Not surprising, the Deloitte/U.Conn Study triggered both an academic and industry practices debate. In November 2005, a new report co-authored by one of the Wharton Study authors[34] criticized the methodology (citing flawed data and actuarial errors) and findings of the insurer-financed Deloitte/U.Conn Study. Subsequently, Brian Smith, President of the Life Settlement Institute ("LSI")[35], commented on behalf of LSI, "Consumers should be provided with accurate information about their life insurance policies when they are considering the purchase of new life insurance or when faced with the lapse or surrender of a policy. Life insurers' efforts to misinform the public about the secondary market for life insurance should be exposed and condemned…It is wholly self-serving for life insurers to create an inapplicable measure ("intrinsic economic value") to encourage consumers to keep paying premiums on a policy that is simply no longer affordable, no longer meets the policy owner's needs, or is simply underperforming."

While an in-depth discussion of these studies is beyond the scope of this article, several general observations seem appropriate:

- *From an investment perspective*, the Deloitte/U.Conn Study quantifies the comparative asset class return on investment ("ROI") value of life insurance and acknowledges that life settlement value is more favorable than cash surrender value. This perspective explains why: (1) life insurance remains a cornerstone of estate and financial planning, (2) life insurance should be maintained until the insured dies, (3) institutional funders are active participants in this secondary market, and (4) consumers benefit by selling their unwanted, unsuitable, unaffordable, and/or underperforming policies in the secondary market.

- *From a practical perspective,* the Deloitte/U.Conn Study overlooks that fact that life insurance carriers have educated their agents for decades to sell life insurance for its "protection" benefit, not as an "investment". While the study's investment perspective is informative, it conflicts with the traditional "needs based" planning rationale underlying the purchase of most life insurance policies. Moreover,

[23] "Life Insurance Long View – Life Settlements Need Not Be Unsettling", Bernstein Research Call (3/4/05). "Another frequently discussed challenge is a natural comparison to the rather ugly history of the viaticals industry. In the 1980s, a number of firms began offering financial-distressed AIDS patients cash for their life insurance policies. These viatical companies (i.e. based on the Latin phrase for "traveling money") purchased policies at a discount to their face values and sold them as retail investments. The practice was controversial for two reasons: 1) the public was generally leery about any practice that appeared to prey on the terminally ill; and 2) viatical investments skirted SEC regulations, given that they did not meet the pure definition of securities, and were often sold with promises of high returns. As medical treatments for AIDS became more effective, patients began living longer. As such, investors in these settlements, whose returns were largely tied to the timing of death benefit payments, did not achieve their promised returns. State regulators closed down many viatical firms as a result of their aggressive marketing practices. Moreover, some high profile cases involved outright fraud and misuse of investor assets. A notable case in Florida involves Mutual Benefits Corp, which is now the target of a class action lawsuit and an SEC investigation."

[24] *The Life Settlements Market: An Actuarial Perspective on Consumer Economic Value, supra* note 8.

[25] Maple Life Financial Inc., *2006 Life Settlement Industry Outlook* (Jan. 2006).

[26] Baldwin, Jr., "Life Insurance in Retirement Planning", J. Retirement Plan. (Mar./Apr. 2006). See also Jones, Leimberg, and Rybka, "Free Life Insurance: Risks and Costs of Non-Recourse Financing," 33 ETPL 3 (July 2006).

[27] For a comprehensive analysis of SOLI, see Leimberg, "Stranger-Owned Life Insurance ('SOLI'): Killing the Goose That Lays Golden Eggs!," 32 ETPL 43 (Jan. 2005)

the purchase decision by sophisticated life insurance owners generally includes an "exit strategy" based on policy surrender value. Carriers continually introduce new products in response to consumer demand and their agents are given incentives to sell these products. As a result, "exit strategy" planning has significantly benefited policy owners, carriers and agents for the past 25 years, and the enhanced "exit strategy" provided by the secondary market should continue to benefit all parties.

Further, the Deloitte/U. Conn Study fails to consider that today's policy crediting rates for in-force universal life and adjustable life policies are generally at or near their contract minimums. To achieve originally illustrated policy values and "protection" expectations, scheduled premiums (that assumed a higher crediting rate[36]) must be increased significantly. Variable universal life policies face the same premium adequacy dilemma if the originally illustrated gross rate of return assumption to calculate the premium was greater than 6 or 7%. In either case, the increased cash flow commitment may be unaffordable. The problem of chronic premium inadequacy, generally attributable to mistaken reliance on carrier illustrations, comes at a time when new life insurance products such as "no lapse guarantee" universal life are being introduced into the marketplace. This type of policy is more premium-efficient, especially when a life settlement increases the 1035 exchange value into a new policy. Further, the type of policy generally will not facilitate a future exit strategy unless it is sold into the secondary market. For seniors confronted with a failing policy and practical cash flow constraints, life settlement can be an important component of the policy rescue recommendation.

We believe the two studies (discussed above), taken together, appropriately explain the consumer value of the primary and secondary markets as well as identify the transparency issues that need attention. Most life settlement applications are submitted by life insurance agents, and most life settlement proceeds are reinvested in insurance products. Agent education and full disclosure are shared goals of each industry. We concur with the conclusion of the 2006 Conning Report[37]: "Life settlements seem to be an appropriate additional tool to help insureds with financial planning. However, aggressive marketing of settlements, especially in the absence of full disclosure of all available options, is not likely to be in the best interests of either insureds or insurers. Techniques need to be developed to structure this marketplace, something that will require cooperation between insurers and life settlement professionals."

The bottom line is that professionals have a duty to inform and educate their clients as well as to demonstrate competence in so doing. Determinations regarding product suitability must consider a client's current needs and risk tolerances. Life insurance vs. life settlement investment and practical trade-offs can reasonably be evaluated for each client situation, and appropriately communicated to, and affirmed by, the client.

Leimberg: ***Please expand on the "investment perspective".***

Whitelaw: Both the Deloitte/U.Conn and Wharton Studies explain to consumers and professionals (1) the economic value of life insurance as compared to other asset classes and (2) the secondary market as compared to policy surrender or lapse. In summary, the Deloitte/U.Conn Study explains the investment opportunity that has attracted significant institutional life settlement funding, and the Wharton Study explains why a "fair market value" offer can be more favorable to the policy seller.

Leimberg: ***Also, please expand on the full disclosure/transparency concern.***

Whitelaw/Weber: Full disclosure of life insurance "soft dollar" commission and life settlement fee compensation, the use of sales and in-force illustrations, determination of premium adequacy, policy spreadsheeting comparisons, and the life settlement "bidding process" should be demanded by professional advisors and fiduciaries. Full disclosure must avoid factual omissions of "knowable" information.

Leimberg: ***What is the outlook for the life settlement industry?***

Colosimo/Weber/Whitelaw: From a growth perspective, Bernstein Research Call has forecasted**,** "We expect the life settlement business, an emerging secondary market for life insurance, will grow more than ten-fold to $160 billion over the next several years. Settlement companies purchase unwanted or unneeded life insurance policies from individuals and ultimately collect the death benefits. These payments are passed on to third-party institutional investors who are looking for returns that are not correlated with existing portfolios. A key component to this growth expectation is that business is conducted in a responsible manner. Poor sales practices by settlement firms could hamper growth and spark a new wave of litigation."[38] Because reliable data is limited, such growth estimates are based on frequently challenged assessments of unwanted, unsuitable, and

[28] *Life Settlements – The Concept Catches On*, *supra* note 19.

[29] *Life Insurance Finance Association Statement on Insurable Interest* (3/24/06). "Last year, the national Association of Insurance Commissioners (NAIC) and state legislators in their roles as state policymakers began investigating certain transactions which have come to be variously described as "investor-initiated", "stranger-owned" and "charity-owned" life insurance. Unfortunately, in an effort to uncover those transactions which may violate insurable interest laws, state policymakers have cash an overly wide net which may inadvertently capture legitimate premium financing transactions. LIFA, along with others in the life insurance premium finance industry, the life settlement industry, life insurers, legislators and regulators, objects to any transaction which violates state insurable interest laws. For example, certain "charity-owned" or "investor-initiated" deals are so named because they are initiated by a disinterested third party and structured in such a way that leads to an inescapable conclusion that life insurance proceeds are destined, from inception, to end up in the hands of that disinterested third party. There are, however, a number of transactions in the marketplace today which provide legitimate premium financing to consumers who need a source of funds to help meet their life insurance needs, and these transactions are being swept up in the overly broad condemnation of all premium financing, thereby threatening the very existence of this critical and consumer-friendly industry."

[30] See note 19, *supra*

under-performing policies. As a result, more attention should be paid to the catalysts for, and/or inhibitors to, industry growth.

In our opinion, the industry outlook should be viewed from a broader planning and asset class perspective rather than a numbers perspective. The secondary market redefines the liquidity and asset value characteristics of the life insurance asset class for insureds age 65 and older, especially seniors with impaired health. Given the aging population, the new generation of insurance products designed for seniors, and the availability of a secondary market, appropriate management of the life insurance asset class for seniors today has little resemblance to yesterday's practices.

Conclusion

Leimberg: ***Can you sum up your thoughts on life settlements?***

Colosimo/Weber/Whitelaw: A life insurance policy is personal property and, therefore, can be sold by its owner. The secondary market demonstrates the enhanced liquidity and asset value available to seniors for about-to-lapse, unwanted, or unsuitable life insurance policies. Failure to disclose the life settlement option creates a "transparency" issue for professional advisors and fiduciaries who have not integrated this option into their respective practice management and standard of care procedures.

Professionals play a key advisory role in the management and restructure of policies held by their senior clients. The age 70 to 90 population, the "silent generation", relies on its advisors to identify changed circumstances such as life insurance policies warranting life settlement consideration. Unfortunately, many life insurance agents and registered representatives are restricted from discussing life settlements with their clients, and many policies insuring seniors are "orphans" without an assigned agent servicing the policy. Resolution of questionable practices affecting life settlement and life insurance marketing and transparency should not delay professional advisors and fiduciaries from exercising their management duties to clients.

In general, life settlement creates a new dimension – perhaps even a *paradigm shift* – to estate and financial planning for seniors that requires life insurance to be actively managed no different from fixed income, equity, and real estate asset classes. The secondary market continues to experience dramatic growth because it (1) addresses a basic consumer demand no different from the secondary market for securities and real estate, and (2) attracts established and credible sources of institutional funding. And, established institutional funders are imposing a "corporate governance" discipline on the transaction process that is intended to minimize the questionable practices described in this article.

From a fiduciary duty perspective, professionals must consider what is their potential liability if a client is not informed of the life settlement option at the time of a policy lapse or surrender or exchange? These risk/reward tradeoff questions reinforce the importance of ongoing communication between the advisor/fiduciary and the client to confirm current objectives, needs, and risk tolerances. Professionals are accustomed to these questions and understand the scope of evaluation necessary to (1) support a client recommendation, (2) obtain client affirmation, and (3) appropriately document performance of their fiduciary duties. Further, if these professionals lack the requisite expertise and capabilities for this evaluation, they can engage the assistance of a life settlement consultant.

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[31] See note 8, *supra*

[32] See note 3, *supra*

[33] "Perceived Benefits of Life Settlements Revisited," *The Life Settlements Market: An Actuarial Perspective on Consumer Economic Value, supra* note 8: "Now that we have developed an analytical framework to compare a Life Settlements sale to the other two options of surrendering a policy or retaining a policy until death, we can analyze the various perceived benefits of Life Settlements from an actuarial and financial perspective".

[34] Singer and Stallard, Reply to *The Life Settlements Market: An Actuarial Perspective on Consumer Economic Value* (Nov. 2005): "In this article, we review the DeloitteConsulting – University of Connecticut Actuarial Center Report ("Carriers' Report) on the secondary market for life insurance. We identify several problems with the actuarial model used by the authors, including the use of mortality tables, tax assumptions, and impairment levels. Setting aside those serious actuarial errors, most of the study's findings violate basic economic logic. The study argues that holding a policy until death is the best strategy for policyowners in almost every contingency. While it may be true that holding a policy until death maximizes the value of the policy at the time of death, it does not necessarily follow that such a strategy is the utility-maximizing strategy for all policyowners at any point in time before death. The Carriers' report concludes that participation in the secondary market generally harms policyowners, and greater regulation is therefore needed. Because these conclusions are based on faulty premises, they should generally be ignored".

[35] Life Settlement Institute was formed by four institutionally-funded life settlement companies and works with government regulatory agencies, legislators and the life insurance industry to promote compliance of strict regulations and comprehensive standards and practices for life settlements.

[36] Whitelaw and Weber, "TOLI Risk Management for Professional Advisors", Steve Leimberg's Estate Planning Email Newsletter, Archive Message #891 (11/6/05).

[37] *Life Settlements – The Concept Catches On*, *supra* note 19.

[38] "Life Insurance Long View – Life Settlements Need Not Be Unsettling", Bernstein Research Call (3/4/05).

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