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HELPING BROKERS BUILD A MORE SUCCESSFUL BUSINESS

Clients May Hold Millions in Untapped Insurance Wealth, Study Finds

By Brian Brooks and Elizabeth Baird

A draft report recently completed by economists at the University of Pennsylvania's Wharton School and Criterion Economics LLC in Washington, D.C., found that holders of life insurance policies who sold their policies to life settlement providers this year received $242 million in excess value that would have been forfeited to insurers.

The Wharton report, based on estimated 2002 figures, notes that among all insurance policies sold in life settlements in 2002 (estimated at $1.5 billion in face coverage amount), life settlement providers paid $336.3 million to acquire policies that had a collective cash surrender value of only $93.4 million.

The study also notes that life settlements increase 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 settlements than from policies that are not assignable. The report concludes that a "secondary market" for life insurance improves the financial well-being for both policyholders and financial advisors.

Currently, the vast majority of life insurance policies either lapse before the end of their term or are surrendered before benefits are paid. Life settlements are transactions in which an insurance policyholder sells his insurance policy to a life settlement provider for cash compensation, often using the proceeds to purchase a different investment or other financial product.

Life settlements include "viatical settlements," in which a settlement provider purchases policies from policyholders who are terminally ill. In recent years, however, relatively healthy policyholders also have been selling their insurance coverage because they no longer need its protection. Rather than paying for unneeded insurance or dropping the policy — which provides a windfall to the insurer — the policyholder can sell the policy to a life settlement provider, which assembles pools of policies to serve as collateral for investment products purchased by institutional investors. In effect, these life settlement provider companies have created a viable secondary market for insurance.

Nearly a third of the current life settlement market involves no-longer-needed key-man policies, originally purchased to protect a company from financial loss of a key executive's services. Another important user of life settlements are trusts that own insurance on the life of someone who has decided either that the trust should hold a more liquid asset or that, due to some change in circumstance, the objectives of the trust have changed. Other policyholders seeking life settlements include retirees who can no longer afford their policies, individuals with life-shortening health problems, and people whose financial needs, business situation, estate size, or marital status have changed since the policy was issued.

The potential market for life settlements — which was just $50 million in 1990 — has been estimated to be as large as $134 billion. To help their clients, financial advisors should understand the basics of the life settlement business. Here are some of the ABCs:

• **The Policy Buyers.** Life settlement providers are companies — typically licensed by a state insurance department (though a license is not required in some states) — that buy policies from policyholders for an immediate cash settlement. Some of the biggest names in the business are Coventry First, of Fort Washington, Penn.; Life Capital, San Diego, Calif.; Life Equity, Hudson, Ohio; Peachtree Life Settlements, Norcross, Ga.; Living Benefits Financial Services, Minnetonka, Minn.; and Stone Street Financial, Bethesda, Md. These firms recently formed the Life Settlement Institute to promote the creation of compliance standards for life settlements.

• **Payments.** Once these companies buy policies, they pay the premiums until the death of the insured. This transaction, in which a life insurance policy is sold by the policyholder to a licensed settlement provider, is commonly referred to as the "settlement" or "front-end" transaction. The sale of the policy or an interest in it by the settlement provider to one or more investors is known as the "investment" or "back-end" transaction. The settlement provider or the ultimate investors collect the policy proceeds when the original policyholder dies.

Settlements can be substantial. In one recent settlement, a policy with $1.25 million in coverage and $190,000 in cash surrender value was sold for $415,000. In another, a policy with $815,000 in coverage and only $2,000 in cash surrender value was sold for $140,000 — a total of $368,000 in economic value delivered to policyholders that would have been retained by insurance carriers if the policyholders merely had surrendered their policies.

• **Carrier Opposition.** Some insurers are trying to block the growth of the industry and limit what they see as competition for policy surrenders (in which a policyholder surrenders a policy to the issuing insurer in exchange for a predetermined cash payment). In the most extreme cases, insurers prohibit agents from advising their clients of the availability of life settlement options, even when a life settlement would be the most suitable financial choice for a particular client. Some insurers and insurance trade associations are telling agents that life settlements pose inherent fraud risks to clients, that life settlement activities are subject to federal securities regulations, and generally that life settlements should be viewed skeptically and approached with extreme caution. On occasion, insurers' broker-dealer affiliates have sought to discipline or even terminate the employment of agents or brokers on the ground that facilitating life settlements constitutes an unauthorized private securities transaction in violation of industry rules.

• **The Legal View.** The prevailing view of courts and regulators is that front-end settlement transactions are not "securities" within the meaning of the federal or state securities laws. In fact, the North American Securities Administrators Association (NASAA) recently published proposed guidelines for viatical investments that specifically state that the front-end transaction is not a securities transaction subject to regulation. This position is consistent with both the National Association of Insurance Commissioners' Model Viatical Settlement Act and state regulatory interpretations.

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 settlement transactions.

• **For Brokers.** 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.

• **What to Do.** A financial advisor whose client has for any reason decided that there are better financial alternatives to holding a current life insurance policy simply needs to obtain a questionnaire from a life settlement provider. The completed questionnaire and authorization allows the life settlement company to review the information and determine the appropriate valuation. Should it turn out that the market value of the policy is greater than the cash surrender value (and the policyholder otherwise satisfies basic eligibility requirements), the transaction may well be suitable to the policyholder's financial needs. If the policyholder decides to proceed with the transaction, a closing package is issued along with various forms, including change of ownership and beneficiary forms. Upon verification of this information, the sale of the policy is finalized and funds are sent to the policyholder. In nearly all instances, the financial advisor receives a commission on the settlement transaction itself from the life settlement provider.

While not appropriate for every policyholder, a life settlement is often an appropriate option. And because of the financial impact, financial advisors have a duty to educate policyholders about the settlement option, as well as an opportunity to increase their business by doing so.

Brian Brooks and Elizabeth Baird are attorneys in the Washington, D.C. office of O'Melveny & Myers LLP and can be reached at bbrooks@omm.com and ebaird@omm.com, respectively.

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