



Life Settlements: Risk Management Guidance for Professional Advisors and Fiduciaries

The first part of a two-part article explores 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.

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

The secondary market for life insurance policies has introduced a new dimension to estate and financial planning, and enhanced the asset management options available to professional advisors, fiduciaries, and their senior clients. Specifically, the emergence of this market redefines the liquidity and asset value characteristics of the life insurance asset class for seniors and consequently, the requisite expertise expected of professionals by their older clients. While many professionals may be familiar with the terms "life settlement" and "senior settlement", they may not be aware how to prudently access this secondary market or how to

mesh life settlements with other contemporary life insurance tools to maximize the cash flow and tax leverage planning of their clients age 65 and older.

For purposes of this article, we will refer to the duties of "professional advisors" (attorneys and CPAs) and "fiduciaries" (trust officers or individual trustees of life insurance trusts). We will explain why these professionals must understand the pros and cons of life settlements, how professionals can determine the economic value of life settlements on behalf of their cli-

ents, and how advisors can ensure a life settlement transaction is conducted in an ethical, legal, and economically responsible manner. In describing "best practices" standards, we will review contemporary life settlement mechanics, uses, and current industry issues. Further, we will describe how this option should be incorporated into professional practice management and fiduciary standards of procedural prudence. Consistent with the way in which all 50 state insurance departments define a licensed life insurance agent, we do not include life insurance agents under the "professional advisor" umbrella.

Seniors are frequently described as the "silent generation" because they typically tend not to get immersed in the details of their estate and financial planning; rather, they rely on the analysis and recommendations of their professional advisors. Because the secondary market opportunity is limited to seniors and insureds with impaired health, professionals must understand their fiduciary duties and the associated accountability for documented performance of these responsibilities. As is explained in more detail below, life settlement is a sophisticated transactional component of a life insurance policy restructuring process that requires credible evaluation of product suitability, full disclosure, and affirmation by the client. If professionals lack the requisite life insurance/life settlement expertise, they must seek guidance from, and delegate appropriate life settlement transaction duties to, a life

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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settlement consultant who specializes in this restructuring process.

How life settlement works

Leimberg: Let's define a life settlement.

Whitelaw: A life settlement, also known as a senior settlement, is the sale to a third-party purchaser of an in-force life insurance policy for its "fair market value" - an amount in excess of the contract's cash surrender value but less than its death benefit. The policy owner/seller is not restricted in use of the cash proceeds received from the sale. In return for the cash payment made to the former policy owner/seller, the settlement company acquires ownership of the policy, names itself the beneficiary, is solely responsible for future premium payments, and will eventually receive the policy proceeds at the insured's death.

Leimberg: How is a life settlement different from a viatical settlement?

Weber: A viatical settlement is the sale of an in-force life insurance policy insuring a person who is terminally or chronically ill. IRC Section 101(g)(4) (A) deems a person *terminally* ill if he or she is certified by a physician as having an illness or physical condition that can reasonably be expected to result in death within 24 months of the date of physician certification. A *chronically* ill person is defined as any person, other than a terminally ill person, certified within the preceding 12-month period by a licensed health care practitioner as:

1. being unable to perform, without substantial assistance, at least two activities of daily living for a period of at least 90 days due to loss of functional capacity;
2. having a similar level of disability as determined by the IRS in consultation with the Department of Health and Human Services; or
3. requiring substantial supervision to protect the person or others from threats to health and safety due to severe cognitive impairment.

A qualifying viatical should result in a

cash offer of 50% to 80% of the policy death benefit. A viatical settlement receives the same income tax-free treatment as if the insured died and was entitled to the provisions of Section 101 (a).

A life settlement, on the other hand, applies to a longer time frame (typically a life expectancy of 25 to 144 months) and will generally be sought for other economic reasons, such as when an existing policy is no longer needed or premiums are no longer affordable. Whereas viatical regulations are reasonably addressed by the various state insurance departments and their taxation by federal Tax Code, currently there are fewer state law regulations governing life settlement transactions and their federal and state tax treatment is far less clear or certain.

Leimberg: Is a Living Benefits Rider an alternative to a life settlement?

Weber: No. A living benefits rider is a provision added to a life insurance policy which offers a benefit similar to a viatical settlement. The qualification for benefits is the same as for a viatical, but policy ownership is not transferred to the life insurance company. The total death benefit is paid to the policy owner and beneficiary in two forms: a portion (typically not more than 50%) is paid to the policy owner during the insured's lifetime and the balance (if the policy is still in force) is paid to the beneficiary at the insured's death.

Leimberg: Who are the parties to a life settlement?

Whitelaw: Party titles and industry terminology are confusing and can vary from state to state. While life settlements are different from viatical settlements, some states include life settlements as part of their viatical settlement legislation. Professionals are expected to understand the parties and their distinct functional roles for the state in which they are transacting either a viatical or a life settlement. In the case of life settlements, the relevant parties are as follows:

- *Policy owner* is the person/entity who has the right to sell the policy.

- *Insured* is the person covered under the policy. The insured may or may not be the policy owner. If the policy owner is not the insured, the policy can be sold to the life settlement purchaser only with the insured's consent.

- *Broker* is the person/entity who represents the policy owner and is licensed to do so, if state licensing for viatical/life settlement sales is required. The broker owes a fiduciary duty to the policy seller to act according to the seller's instructions and in the best interest of the seller. The broker typically performs the following functions:

1. Obtains basic information from the prospective seller to assess the probability that a policy can be successfully sold.
2. Prepares a Request for Proposal ("RFP"), identifies institutionally-funded providers based on RFP criteria, and confirms necessary application information with each provider.
3. Submits RFP to institutional providers.
4. Evaluates responses to RFPs to determine the most advantageous offer.
5. Confirms acceptance of the offer and coordinates execution of closing documents.
6. Provides a cost/benefit analysis to the seller, comparing the decision to sell versus not sell.
7. Summarizes the transaction and compensation for the seller to ensure full disclosure and avoid factual omissions.

- *Provider* is the person/entity that effectuates a life settlement contract and manages the transaction on behalf of a third-party purchaser. The provider typically performs the following functions:

- ◊ Confirms that all documents conform to applicable state or federal statutes, laws, and regulations relating to consumer protection, life insurance, and life settlement prac-

- ties and procedures.
- ◊ Obtains life expectancy calculations from approved life settlement consulting actuaries.
- ◊ Performs policy examination.
- ◊ Determines the amount of the “fair market value” offer.
- *Purchaser/funder* is the person/entity who gives a sum of money in consideration of a policy and is entitled to a beneficial interest in a trust that owns one or more policies. In some instances, a purchaser/funder may also be a provider.
- *Independent escrow agent* is an entity designated by the provider and recognized by governing state authority (i.e., the Insurance Commissioner) to accept, transmit, and pay the proceeds of a life settlement.

Leimberg: *Explain how the secondary market works.*

Whitelaw: The key to maximizing the probability of a successful policy sale and optimizing the fair market value offer to clients is for professionals to understand that *all life settlement brokers and funders are not alike*. First, it is critical to engage an experienced broker that can access the competitive market of institutionally-funded providers. Selecting an inexperienced broker usually limits the “bidding process” to one provider with purchase criteria that may or may not be a good match for the policy to be sold. The use of multiple brokers may disrupt the secondary market bidding process and, potentially more disturbing, places the professional in the awkward position of having to undertake his or her own due diligence evaluation of competing offers. So it's typically best to find and use a broker who works exclusively in the secondary market.

Second, to maximize the amount of the offer for the policy, it is essential to submit an application to established institutionally-funded providers using a Request for Proposal process. Provid-

ers may represent one or multiple institutional funders with different preferences as to life expectancy, policy type, and face amount, as well as different objectives regarding the cost of capital and return on investment. Also, established providers continually attract new institutional funds to broaden the range of policies they can purchase.

Leimberg: *Explain what most sellers do with the money they receive from life settlements.*

Weber/Whitelaw: Studies estimate 85% of life settlement proceeds are reinvested in new financial products such as life insurance policies, annuities, and long-term health care policies. Considering estate tax uncertainties and the changing needs of our aging population, life settlement adds a new dimension to estate and financial planning for insureds age 65 and older. “Life settlements actually benefit those who have become greater-than-average risks. Moreover, because the existence of a secondary market for life insurance has improved the liquidity of all life insurance policies that might potentially qualify for settlement, the secondary market makes policies in the primary market more valuable for all consumers, regardless of their current state of health. As more policyholders become aware of the opportunity presented by viatical and life settlements, and as it becomes possible for more policyholders to obtain the fair market value of their policies, consumers will perceive an increase in the quality of life insurance, which will have a positive effect on the demand for life insurance.”¹

Without question, the liquidity and fair market value benefits of life settlements significantly change the “economics” of traditional life insurance planning for seniors. In-force life insurance policies on older insureds now represent a “springing” multi-purpose financial asset value, but the choices are not necessarily clear or without some risks. Professionals must help their clients identify planning situations appropriate for life settlement. They must also structure the transaction to maximize the value of their clients’ unwanted, unsuitable, un-

affordable, or under-performing in-force policies, while minimizing risk.

Leimberg: *Can any type of policy qualify for a life settlement?*

Weber: Most life insurance policy types qualify for life settlement, including universal life, adjustable life, whole life, survivorship, joint first-to-die, and even individual term and group term insurance, if convertible (and assignable). Variable policies also qualify but are problematic, and will be addressed in Part 2 of this article.

Leimberg: *What are the typical life settlement eligibility requirements?*

Weber: Life settlements have two categories of eligibility requirements. First, the insured’s life expectancy must be between 25 and 144 months based upon one or more life expectancy calculations, and the insured must be at least age 65 unless health impairment has shortened the insured’s life expectancy. Second, policy requirements generally include:

- A minimum policy face amount of \$250,000.
- The policy must be beyond the two-year contestable period, subject only to payment of premiums.
- The policy must not be subject to restrictions (e.g., a split dollar arrangement) that would prevent payment of a death benefit to the settlement company at the insured’s death.
- The underwriting carrier must verify that the policy is in-force and not encumbered by any other party.
- The underwriting carrier must have a BBB or more favorable third-party rating.

Leimberg: *What factors does the settlement company use to determine how much to pay the seller?*

Whitelaw: The amount paid to the seller depends on the insured’s estimated life expectancy, ongoing policy expenses (primarily the premium or the

¹ Doherty and Singer, *The Benefits of a Secondary Market for Life Insurance Policies*, (Wharton School, University of Pennsylvania, October 2002). See also Doherty and Singer, “The Benefits of a Secondary Market for Life Insurance Policies,” 38 Real Prop., Prob. and Tr. J. 451 (2003).

cost of insurance), current policy benefits (primarily the death benefit but accumulation and cash surrender values are also considered), and the purchaser's processing costs, cost of capital, and internal rate of return objective.

Leimberg: *Can you elaborate on life expectancy calculation?*

Whitelaw: Providers obtain between one and four life expectancy calculations, depending on variables such as the insured's medical information, policy type, face amount, contract maturity, underwriting carrier, and other relevant funder requirements. When multiple calculations are obtained, a provider may formulate its offer using the most conservative calculation or an average of them. Four major life expectancy analysis firms² specialize in these calculations. The reliability of their respective calculations is recognized by both providers and institutional funders.

The difference between underwriting life insurance and life settlement applications should also be noted. Life insurer "protection" pricing assumes an insured will live to contract maturity whereas life settlement fair market value "purchase" pricing is time-specific.

For example, life insurers seek preferred and standard medical risk applicants at all ages, and price their life insurance protection offer by assuming the insured will live to contract maturity, insured age 95, 100, or 100+ (a discussion of ultimate mortality tables as well as adverse selection and non-forfeiture considerations is beyond the scope of this article). Once the offer is accepted and the policy is issued, the underwriting rating does not change except for a time-specific "flat extra" offer or an insured's request due to more favorable medical history. By comparison, life settlement providers seek impaired risk and/or older age applicants with a life expectancy generally of 12 years or less. Providers price their "fair market value" offer by assuming death in the time period calculated by a life expectancy analysis of the insured's medical history.

Details of the life settlement process

Leimberg: *Explain how the life settlement process works mechanically.*

Whitelaw: Transacting a life settlement is a relatively simple process that usually takes 6 to 10 weeks. The first step is completion of a Qualifying Worksheet that considers the insured's age, medical history, policy type, and current policy values in order to assess preliminarily the probability that a policy can be successfully sold.

Next, a completed application is submitted to multiple providers along with authorization forms for the release of the insured's medical history and policy information. A medical examination is not required; however, an exam by a physician within the past 12 months optimizes the probability of an offer for the policy's fair market value. If an application meets a provider's guidelines, the provider, on behalf of a funder, makes an offer based on the insured's life expectancy, policy type, current premium payment, insurance company rating, and policy provisions. When the policy owner/seller accepts an offer, a life settlement contract is executed, and the closing activities and time schedule for payout are confirmed.

Ideally, the provider will deposit the contract amount with an independent escrow agent who transfers the sale proceeds to the seller within three business days of the date the insurance company confirms to the provider that ownership transfer has been completed. The policy is then absolutely assigned to the provider. Thereafter, the provider pays all premiums and is the policy owner and beneficiary. The provider has the contractual right to periodically obtain information as to health status from the insured or insured's representative for as long as the insured lives.

Leimberg: *Won't some insureds be concerned that an unscrupulous party may acquire a financial interest in their demise – and the sooner the better?*

Weber/Whitelaw: This concern is not new to the life insurance industry. A policy beneficiary has a financial interest in the demise of an insured whether the owner is an individual, business, trust, charity or institutional life settlement purchaser. A life insurance return-on-investment ("ROI") calculation always favors early demise and decreases as a percentage over time. Businesses, charities, and trusts are institutional life insurance owners with an ROI objective no different from an institutional life settlement purchaser. If an insured is uncomfortable with institutional ownership, then he/she should not be a party to the life insurance transaction. A life settlement cannot be transacted without the insured's written agreement.

Professional advisors and fiduciaries should understand the safeguards available to an insured in a life settlement transaction. First, the insured must formally agree to the transaction, authorize the release of medical information, formally solicit his/her physician's cooperation for informational requests, and agree to provide periodic updates concerning his/her health to the new policy owner. Second, most institutional funders do not have access to information about the insured or the policy. Funders contract with a provider who purchases policies on the funder's behalf and in accordance with specific investment criteria. The provider-purchased policies are held in trust and managed by a corporate trustee. Third, many states provide oversight in the form of provider licensing, bonding and reporting requirements. Finally, a portfolio of policies can be sold by an institutional funder, and the sale typically would be to another institutional funder.

Leimberg: *How does a buyer monitor the insured's health status and know when the insured has died?*

Weber/Whitelaw: Institutionally-funded providers employ practices intended not to bother the insured. For example, most providers use the Social Security Administration's public database, which "frees up" a social security number when someone dies. Providers

² American Viatical Services, Fasano, Examination Management Services, Inc. and 21st Services.

contractually have the right to periodically call a person designated by the insured to inquire about the insured's health status. However, such contact tends to be infrequent when the policy is purchased by an institutional funder.

Reason for selling a policy

Leimberg: *Go into more detail about the typical reasons to consider selling an existing life insurance policy.*

Weber: The owner of a life insurance policy can sell either all or part of a policy. The basic reasons to consider a sale are:

- The policy is no longer needed by the owner, and a sale for the "fair market value" will generate proceeds in excess of the cash surrender value.
- Notice of a lapse has been or is about to be received and/or premium payments are no longer affordable, and a sale for the "fair market value" will generate proceeds that wouldn't otherwise be available from a lapsing policy.
- The policy is no longer suitable or affordable or is significantly under-performing the original policy expectation³, and analysis indicates it should be exchanged for a more efficient product.
- The sale will generate a higher amount of cash which could then be placed into a new policy, thus requiring a lower ongoing premium commitment or providing a higher death benefit from the existing premium commitment.

Leimberg: *Please elaborate. What situations are appropriate for Life Settlement?*

Whitelaw: Individuals, businesses, trustees and charities should consider life settlement when circumstances dictate a change in investment strategy.

Individuals

1. A change in the size of the estate requires a larger or smaller death benefit policy
2. Increase in the federal estate tax exemption may eliminate some or all of need for liquidity.
3. A different policy type provides more suitable and/or efficient life insurance coverage.
4. Cash is needed to pay off debt or resolve financial difficulties.
5. Funds are needed for long-term health care insurance.
6. Premiums are no longer affordable and the policy is in danger of lapsing.
7. The policy owner prefers to reallocate cash value and future premiums to another asset class.
8. Protection for the beneficiary has become unnecessary due to death or divorce.
9. The employee/insured is about to retire and chooses not to "convert" his/her group term life insurance.

Businesses

1. Keyman insurance is no longer needed due to retirement or a change in business structure.
2. Buy/sell agreement and related insurance coverage is no longer needed.
3. Executive benefit planning has changed and business-owned policies are not needed.
4. Cash is needed to reduce debt, purchase stock from a shareholder, or fund other business opportunities.
5. Cash is needed to satisfy forced liquidation or bankruptcy obligations.

Insurance Trusts

1. Liquidity from an insurance policy is no longer needed due to gifting or other estate asset/tax law changes.
2. Change in the objectives of the trust requires a larger policy or different policy type.
3. Policy under-performance requires restructuring to avoid lapse or un-

³ Weber, "When is a Premium Not a Premium", Journal of Financial Service Professionals (July 2005).

⁴ Warring, "Turn Unneeded Policies Into Cash: A Life Settlement Can Be A Better Alternative Than Surrendering A Policy", Journal of Accountancy, Vol. 200, No. 3 (September 2005).

⁵ *Life Settlements – The Concept Catches On* (Conning Research & Consulting, Inc., 2006). "2005 Life Settlement Study", Agent's Sales Journal, Agent Media.

manageable costs.

4. The trustee prefers a guaranteed death benefit policy.

Charities

1. The donor prefers a larger current gift amount and tax deduction.
2. The charity can no longer afford the premium payments, and the policy is in danger of lapsing.
3. The charity has requirements for current working capital and/or capital expansion.

Duty associated with life settlements

Leimberg: *Does the professional advisor or fiduciary have a duty to discuss the life settlement option with the client if he or she is aware of the impending lapse of client's life insurance policy or other circumstances warranting a change in insurance strategy?*

Colosimo: Yes. It would be very difficult for a professional to assert ignorance of this widely accepted and publicized strategy. A 2005 study of professionals by Maple Life Financial, a Maryland-based life settlement provider, found that 45% of survey participants had clients over age 65 who surrendered a life insurance policy for its cash value. Many of these individuals could have qualified for a life settlement and obtained a cash payment significantly in excess of the policy's cash surrender value. For example, cash surrender values average just 4%⁴ of policy face amounts while life settlements average 25-30%⁵. We advise professionals to identify life insurance policies and client situations appropriate for consideration of a life settlement.

Professionals cannot assume that a life insurance agent or carrier is informing the policy owner about the life settlement option. A recent market research study⁶ indicated that 52% of surveyed agents never speak to clients about life settlements, 60% do not know enough about life settlements to anticipate a

life settlement transaction within the next 12 months, and 75% do not know their state regulations concerning life settlements. Unfortunately, many agents and registered representatives are restricted from discussing life settlements with policyholder clients for reasons discussed later.

Professionals should pay particular attention to their clients' "orphan" policies. These are policies - most commonly owned by seniors - that are no longer serviced by an insurance agent. This usually occurs when the policy-selling life insurance agent retires/terminates/dies and the policy service function is not assigned by the insurer to another agent. As a result, the policy owner receives the carrier's periodic premium billing notices without the benefit of ongoing policy service. These neglected, often older policies receive no attention with regard to risk management and are fraught with dangers such as lapse or unsuitable status.

Professionals understand that life insurance programs are usually implemented to span a long time horizon. Because they represent a significant cash flow and asset value commitment in funding future obligations and liabilities, these programs require active policy management no different from fixed income and equity investments. Because planning objectives, tax legislation, market conditions, business arrangements, and insurance products continually change, it is necessary for professional advisors and fiduciaries to protect their clients' interests by offering informed policy management (regarding product suitability) and guidance (regarding policy restructure) based on contemporary options. Failure to inform a client about life settlement under such changing circumstances denies the policy owner an important financial opportunity. "And because of the financial impact, financial advisors have a duty to educate policyholders about the settlement option..."⁷

Leimberg: Should a corporate (institutional) trustee be familiar with life settlements?

Colosimo/Whitelaw: Yes. The "risk management era" was officially launched with the Sarbanes-Oxley Act (2002). The corporate malfeasance scandals of 2000 – 2001, ongoing investigations of financial institutions, and well-publicized settlements frame today's expectations as to corporate governance and "best practices". These events demonstrate the importance of third-party oversight and credible second opinions to ensure that financial services are being delivered appropriately, competitively, and consistent with marketing representations.

In his May 2002 article⁸, attorney Dean Edward Miller, Esquire, who previously held various positions at the Office of the Comptroller of the Currency, offered the following opinion: "The emergence of the life settlement has altered the landscape of the insurance trust business. It has presented an alternative course of action for trustees of trusts holding life insurance policies on the life of the settlor. This alternative significantly changes the options available to the trustee in a number of possible fact situations. In some cases, sale of a policy pursuant to a life settlement will redound to the benefit of the trust and its beneficiaries dramatically, providing them with a benefit that may be substantially in excess of what the more limited options previously permitted, or by opening to them an alternative that is more in keeping with their present interests...This (life settlement) alternative enables a trustee to obtain immediate funds to facilitate attainment of the current objectives of the trust, and in the process, eliminate what may be a significant burden of premium payments."

At the forefront of a trustee's obligations is the duty to know and attempt to meet the trust's objectives and to reassess⁹ periodically the feasibility of their

accomplishment. An irrevocable life insurance trust is a special purpose trust that owns a "concentrated" investment; therefore, a trustee's determination necessitates an objective, defensible review of the policy at hand, which requires credible evaluation of premium adequacy and policy performance (i.e., the evaluation must include more than merely reviewing carrier-supplied sales and in-force illustrations that disclaim predictive value). In cases where the policy evaluation, in combination with tax/personal finance considerations, demonstrates that policy retention is inappropriate, life settlement must be considered as a restructuring alternative¹⁰.

Leimberg: Do corporate trustees risk fiduciary liability for failure to consider a life settlement option in appropriate circumstances?

Colosimo: Yes. Support for the proposition that trustees have a duty to offer the life settlement alternative in some cases (where suitable/preferable) can be found in the Uniform Prudent Investor Act ("UPIA"). Section 2 of UPIA, often referred to as the "heart of the Act", states that the trustee is required, in carrying out its responsibilities and managing the trust assets, to consider the purpose, terms, distribution requirements, and all other relevant circumstances of trust accounts under management. In addition, Section 2 (c) enumerates the factors that a trustee must consider when investing and managing trust assets. These factors include: the role that each investment or course of action plays within the overall trust portfolio, the expected total return from income and the appreciation of capital, other resources of the beneficiaries, and the need for liquidity, regularity of income, and preservation or appreciation of capital.

Inherent in the intended purpose and scope of the UPIA guidelines is the fiduciary duty to restructure trust assets that are determined to be unsuitable to

⁶ "2005 Life Settlement Study", Agent's Sales Journal, Agent Media.

⁷ Brooks and Baird, "Clients May Hold Millions in Untapped Insurance Wealth, Study Finds", OnWallStreet (Nov. 2002).

⁸ Miller, "Life Settlements and Trust Accounts: A Possible Modification of the Trustee's Responsibility?" 119 Banking Law Journal 483 (May 2002).

⁹ Attorney Dominic J. Campisi discusses the recent fiduciary litigation and surcharge cases that provide a road map for establishing procedures and reviews of trust department activity for audit employees and risk avoidance personnel, in his article, "Fiduciary Liability Trends", Fiduciary & Risk Management Association Newsletter (Fall 2005).

¹⁰ Whitelaw and Colosimo, "TOLI Risk Management – Guilty Without Proof of Innocence", Fiduciary & Risk Management Association Newsletter (Spring 2004).

the trust's objectives. An eligible insurance policy cannot be considered responsibly restructured if all reasonable alternatives, including life settlement, are not considered. Thus, the prudent trustee must fully apprise him/herself of the factors influencing the life settlement alternative and subsequent transactions.

Leimberg: Does a personal trustee have a similar duty to consider the life settlement option?

Colosimo: Yes. While an unskilled personal trustee may not be held to the same standard of care as a skilled professional trustee, the Prudent Investor Rule comments: "The duty to exercise both care and skill in investment management may require knowledge and experience greater than that of an individual of ordinary intelligence, depending on the investment strategy to be employed. This does not prevent an ordinary intelligent person from serving as trustee. In that role, however, such a person may have to take reasonable steps to obtain sufficient competent advice, guidance, and assistance in order to meet the standards of this Section and to formulate and implement a prudent investment strategy for the particular trust."¹¹"

A personal trustee may reasonably rely on a professional advisor for investment advice. In turn, the advisor has a duty to inform the personal trustee of the life settlement option and ensure that it is appropriately considered and evaluated. If the advisor lacks the requisite investment expertise, he/she should communicate that fact to the trustee and should assist the trustee in obtaining such expertise and capabilities from a life settlement consultant (see Duty to Delegate below).

Leimberg: Can a trust company's website and other marketing materials¹² create liability for their trustees who fail to discuss the life settlement

option?

Colosimo: Yes. Some trust companies and professional fiduciaries use marketing materials that promote their "best industry practices" philosophy. They advertise to prospective insurance trust clients the competency, experience, and wide range of services and activities they perform in managing the trusts they administer. As the significant financial benefits of life settlements gain popularity, the trustee charged with oversight of irrevocable life insurance trusts is expected to demonstrate a level of life settlement proficiency commensurate with clients' reasonable expectations, as fostered by the trustees combined marketing assertions, credentials and title. Liberal boasts of "the most up-to-date" knowledge and access to a "wide variety of investment options" are examples of common representations that make it difficult for trustees to assert a defense for subsequent inaction or lack of informed and complete management advice, including that of life settlement.

Leimberg: Does a trustee have a Duty to Delegate the life settlement transaction to a skilled intermediary and/or broker?

Colosimo: Yes, in the absence of demonstrable in-house life settlement expertise. One of the most significant features of the Prudent Investor Rule is the shift of focus to fiduciary conduct. In accepting a trust, a trustee must demonstrate the requisite expertise and capabilities to manage the trust investment(s). The fiduciary duties of a trustee have become more complex with the introduction of contemporary investment products and with the "best practices" standards implicit in today's corporate governance environment. The Duty to Delegate¹³ under the Prudent Investor Rule encourages a trustee to seek the knowledgeable advice of professionals in the interest of informed decision-making.

Leimberg: To whom should a professional advisor or fiduciary delegate?

Weber/Whitelaw: Because life settlement is one component of a life insurance policy restructuring process, a professional fiduciary¹⁴ should engage a life settlement consultant with the expertise and capabilities to:

- Credibly evaluate management options for in-force policies,
- Credibly compare these options to the life settlement option,
- Select and oversee the life settlement broker,
- Help communicate the restructuring options and recommendations to the policy seller, and
- Summarize the decision to restructure the policy for affirmation by the policy seller.

Further, professional advisors to personal trustees should recommend engagement of a life settlement consultant, and should demand such expertise¹⁵ on behalf of their clients who are beneficiaries of insurance trusts. Finally, it is important for professionals to recognize that all life settlement transactions are not the same. Policies with larger face amounts and variable policies require special consideration. Professionals should assure that the consulting expertise is appropriate for the specific planning and policy situations.

Choosing a broker

Leimberg: What criteria should be considered in selecting a life settlement broker experienced in working with institutionally funded life settlement providers?

Whitelaw: All life settlement brokers

¹¹ Prudent Investor Rule §227 comment d. General Requirements of Care and Skill.

¹² Miller, *supra* note 8.

¹³ See the Prudent Investor Rule §171 Duty with Respect to Delegation, General comment a. Fiduciary duty and discretion.

¹⁴ Prudent Investor Rule §229 comment a, Duty to Restructure Trust Portfolio: "With the trust's investment objectives in mind, the trustee must review the original investments and, if and as necessary, formulate a plan for restructuring the portfolio to achieve a suitable level of risk and expected return with appropriate degrees of diversification and income productivity...The trustee must determine whether the trust terms direct retention or disposition of any of the inception assets."

¹⁵ "Trust-Owned Life Insurance: Risk Management Guidance for Professional Advisors", Steve Leimberg's Estate Planning Email Newsletter, Leimberg Information Services, Inc. Archive Message #891 (11/16/05).

are not alike. Upon determination that a life settlement should be considered, the professional or life settlement consultant should screen brokers based on the following criteria:

1. The number of life settlement transactions the broker negotiated with institutionally-funded life settlement providers in the past year and past three years, and the complexity of these cases.
2. The number of institutionally-funded providers the broker customarily accesses. Confirm that the broker maintains due diligence materials for each of these providers that can be shared with the advisor and policy owner.
3. Confirmation that the broker utilizes a Request for Proposal process that will be submitted to all represented institutionally-funded life settlement providers.
4. Assurance that the broker will disclose all bids.
5. Confirmation that the broker employs a Qualifying Worksheet to ascertain the probability of selling the policy.
6. Proof that the broker is state licensed (or evidence that licensing is not required).
7. Proof that the broker/provider has errors & omissions coverage specifically for life settlement transactions.
8. Confirmation of the fee the broker will earn from the provider for this transaction.
9. Confirmation that the broker will provide a transaction summary fully disclosing the providers contacted, response from each, offers, fees, and other relevant transaction-specific information. This summary must avoid factual omissions.

Next, at the time of application, the professional or life settlement consultant should confirm with the broker the disclosures required by the state of policy owner/seller domicile or trust situs, which generally include:

1. Alternatives to life settlement such

- as accelerated death benefits, policy loans available, etc.
2. Statement regarding possible tax consequences.
3. Statement that proceeds may be subject to claims of creditors.
4. Statement of seller's right to rescission.
5. Statement as to whether Purchaser has the right to resell the policy and the practice history of reselling.
6. If applicable, a guarantee that in the event the policy is resold, the insured will be notified promptly.
7. Confirmation of an independent third-party escrow agent.

The professional should review these considerations and their implications with his/her client.

Finally, at the time of screening offers, the professional or life settlement consultant should re-confirm with the broker the following considerations:

1. The reputation, size, and experience of each life settlement provider and funder.
2. The provider's state licensing, due diligence, and compliance program.
3. The funder's privacy practices concerning periodic communication with the insured and possible resale of the policy.

The professional should review this summary with his/her client to ensure full disclosure and avoidance of factual omissions.

Leimberg: Should an estate planning professional be familiar with life settlements?

Colosimo/Whitelaw: Yes. A May 2000 article entitled, "Unlocking New Value from Old Policies: Life Insurance Planning and Life Settlements"¹⁶, introduced estate planners to the role that life settlements can serve in changing situations: "Life settlements of insurance policies, once entered into almost exclusively by terminally ill individuals, are now becoming increasingly

common among elderly individuals who are not terminally ill. As the life settlement market grows, new options emerge for the estate planning professional. Estate planners need to become familiar with life settlements, how the federal income tax applies to their proceeds, and what incentives a client may have for entering a life settlement." This article provided a comprehensive overview of life settlements and examples of their estate planning, business and charitable giving applications.

The implementation and management of a life insurance program usually results from an economic analysis prepared and periodically reviewed by a policy owner's professional advisors. "While it is 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..."¹⁷

Life settlements frequently involve policies that are failing because they lack sufficient cash value to pay the annual insurance costs and/or the policy owner can no longer afford the premium payments. The secondary market serves both a policy rescue and sophisticated planning purpose, often at the same time. Contemporary life insurance management tools are available to maximize the planning value of these programs, especially to older insureds. "More clients are having to deal with implications of lower yields on their insurance policies, and are choosing to have the cash today rather than all of the insurance for their families tomorrow...Life settlements are having a major impact on estate, financial and insurance planning. It's very important for individual policy holders to understand them – or at least know that the option is out there."¹⁸

Practical examples

Leimberg: Can you share some examples of actual life settlement transactions?

Whitelaw: We've selected five trans-

¹⁶ Adams, Kurlander, and Marlar, "Unlocking New Value From Old Policies: Life Insurance Planning And Life Settlements", 139 Trusts & Estates 44 (May 2000). See also Leimberg and Gibbons, "Life Settlements and the Planning Opportunities they Offer," 30 Estate Planning 517 (Oct. 2003).

¹⁷ Brooks and Baird, *supra* note 7.

¹⁸ Ratner, "Cash Out or Cash In?", 144 Trusts & Estates (May 2005).

actions to illustrate the liquidity and asset value benefits of life settlements. Three policies involve older insureds, with one policy in its “about-to-lapse” period. Another involves a term life insurance policy, which does not have a cash surrender value.

1. A \$4 million corporate-owned policy with a \$500,000 cash surrender value insured an 89-year-old male for keyman coverage purposes. The business had not made scheduled premium payments for several years because the next generation of management was in place, and they had undertaken an aggressive capital expansion program. The policy was within 18 months of lapse, the insured was in good health for his age, and annual premium payments in excess of \$200,000 would be required to sustain coverage. The policy was sold for \$850,000, which represents 21% of the death benefit and \$350,000 more than the cash surrender value. The proceeds were used to internally fund the capital expansion program.
2. A \$5 million trust-owned policy with a \$2,500 cash surrender value insured an 82-year-old female. Following receipt of the lapse notice, the corporate trustee learned that the policy, purchased over 15 years ago, was no longer needed. The policy was sold for \$900,000, which represents 18% of the death benefit and \$897,500 more than the cash surrender value. The sale proceeds were reinvested in fixed income and equity investments.
3. A \$1 million individually-owned policy with a \$140,000 cash surrender value insured a male age 85. The policy was no longer needed for the insured’s estate planning. The policy was sold for \$290,000, which represents 29% of the death benefit and \$150,000 more than the cash surrender value. These proceeds were gifted to a charity. The donor made a larger cash donation, which generated a higher charitable income tax deduction.
4. A \$300,000 individually-owned policy with a \$1,000 cash surrender value insured the male age 89

described in sample #1 above. The policy was no longer needed and was about to lapse. This policy was sold for \$50,000, which represents 17% of the death benefit and \$49,000 more than the cash surrender value. The proceeds were used for lifestyle purposes.

5. A \$1 million *term* insurance policy with *no* cash surrender value insured a 72-year-old male. The policy was no longer needed and sold for \$110,500, which represents 11% of the death benefit, *plus an unexpected \$110,500 cash payment.*

Leimberg: *Can you provide examples of how life settlement proceeds are reinvested in insurance and annuity products?*

Whitelaw/Weber: Yes. Several examples illustrate typical estate planning situations that should be considered by professional advisors.

- Assume the \$5 million of life insurance coverage in case #2 above is still needed and a new policy application is approved. Properly structured¹⁹, the \$900,000 life settlement proceeds can be used as the 1035 exchange amount into a new policy and can significantly reduce the new policy’s annual scheduled premium. Assuming that the 82-year-old female is a standard underwriting risk and that the basis in the original policy is at least equal to the settlement proceeds, the annual premium for a “no lapse guarantee” universal life policy is \$180,000 with the \$900,000 exchange and is \$275,000 without the exchange value. The \$900,000 exchange amount generated an additional annual premium savings of \$95,000 for the insured’s lifetime.
- Assume the \$1 million of life insurance coverage in case #5 above is still needed and a new policy application is approved along with third-party non-recourse premium financing (commitment obtained from an established financial institution with proper disclosures and

exit strategy). The \$110,500 life settlement proceeds can be invested so that investment earnings are used to pay the financing’s annual interest costs.

- Assume a business executive is offered a keyman insurance policy on favorable terms as part of his/her retirement package. Life settlement provides an attractive liquidity/annuity option if the policy is no longer needed for future life insurance protection.
- Assume life insurance protection is no longer needed but long-term care coverage is needed by an older insured. Life settlement can generate a partial or single premium payment for long-term care coverage.
- Assume a policy owner’s life insurance need is less than the current policy’s face amount. The policy can be split so that the reduced amount is maintained, the unneeded amount is sold, and the proceeds used to pay/prepay premiums on the reduced amount of coverage.

Professionals should also be aware that institutionally-funded providers offer purchase programs that address common life insurance management problems. For example, an in-force policy may provide a higher death benefit than is currently needed. In such a situation, the provider may purchase the policy, pay the cash offer, and pay all future premiums, while the policy seller retains a reduced death benefit with no premium payment responsibility.

Part 2 of this article, which will appear in the next issue of Estate Planning, will examine the tax, accounting, and regulatory aspects of life settlements, as well as life settlements involving variable policies.

¹⁹ As will be explained in more detail in Part 2 of this article, there are no Internal Revenue Code provisions specific to income taxation of life settlements.